

S. HRG. 114-163

OVERSIGHT OF THE SECURITIES INVESTOR PROTECTION CORPORATION

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE SECURITIES INVESTOR PROTECTION CORPORATION'S
(SIPC) CONTINUING OVERSIGHT AND PROTECTION OF INVESTORS,
THE AGENCY'S RESPONSE TO RECENT CLAIMS AND CUSTOMER PRO-
TECTION, AND CONSIDERING THE NEED FOR ANY SPECIFIC SIPC RE-
FORMS TO BE MADE

SEPTEMBER 30, 2015

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WEDNESDAY, SEPTEMBER 30, 2015

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE,
AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee convened at 10:16 a.m., in room 538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. This hearing will come to order.

I, first of all, want to thank my colleague and Ranking Member Senator Warner for his help in working together with us on this hearing, and also, I would like to thank Senator Vitter for encouraging our Subcommittee to hold an oversight hearing on the Securities Investor Protection Corporation, known as SIPC, and also thank you, Senator Vitter, for your efforts to help the investors.

SIPC was created by Congress in 1970 to oversee the liquidation of member broker-dealers that close when the broker-dealer is bankrupt or in financial trouble and customer assets are missing. In recent years, SIPC has been the center of attention because of the financial trouble and failure of Lehman Brothers, Bernie Madoff Investment Securities, MF Global, and Stanford Investment Group. Each event has had a lasting effect on investors, the broader sanction, and has highlighted the function of the SIPC.

Today, we continue that discussion with our expert witnesses. Specifically, how is SIPC protecting investors? Specifically, how has SIPC responded to recent claims and customer protection? And are there any specific SIPC reforms that we should consider or that SIPC should consider and why?

I look forward to the testimony of our witnesses today. I think that we have got a very strong panel of strong witnesses who understand this issue well and will give us strong advice.

And with that, let me turn it to you, Senator Warner, if you have any opening statement.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Well, thank you, Mr. Chairman. I want to also thank you for holding this hearing and echo what you said about Senator Vitter.

This is an area—we have heard of SIPC. Frankly, unfortunately, I think we all kind of heard more about it than we perhaps wanted to hear about it and post-Madoff, Stanford, some of the other schemes that have taken place, I am curious to learn more about the fact that different types of securities, cash, CDs, others, seem to have different levels of protection. So, I am anxious to see where we might see reforms.

I do think it is interesting to note that 7 years after the Madoff fraud, only 10 percent of investment advisors are examined annually. That, to me, raises some questions about if we are going to be prophylactic going forward. Rather than simply trying to make sure we rectify things after the fact, we do need some ability to be more proactive on the front end.

So, Mr. Chairman, I have got other comments. I will keep those in reserve so that we can move to the witnesses and get to the questions. Thank you.

Senator CRAPO. Thank you, Senator Warner, and I do understand, Senator Vitter, that you would like to make an opening statement, as well.

Senator VITTER. If I could, Mr. Chairman.

Senator CRAPO. Certainly.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Thank you very much.

First, I would like to make a few items part of the record by unanimous consent. The first is a statement from Richard Sheedam, an investor who has filed a lawsuit disputing SIPC's statement of facts with the SEC on the Stanford issue.

And the second is a statement of Dr. Laurence Kotlikoff, who was scheduled to testify at a similar hearing on SIPC oversight before this Committee earlier this year, but that was rescheduled, and his statement as prepared for delivery.

Senator CRAPO. Without objection.

Senator VITTER. Thank you.

Chairman Crapo and Ranking Member Warner, I want to thank both of you for holding this important hearing on SIPC oversight today. I can tell you, not enough attention is paid in Congress to SIPC and Wall Street has noticed. Wall Street basically runs SIPC their way, and I believe investors really need to beware.

I want to take just a minute before we start to underscore an important point that Dr. Kotlikoff makes in his testimony when he says, quote, "Today, no investor can be confident their assets are protected by SIPC as Congress intended when SIPA was enacted," and I think that is the bottom line and that should concern all of us. I want to associate myself with those remarks.

I think it is important for investors to notice, because broker-dealers across the country plaster the SIPC logo across their doors and their Web sites and all of their literature. Investors are led to believe that if the broker-dealer fails, SIPC will be there to help them. I can tell you from bitter experience watching the Stanford case, trying to help those victims however I can that this is just patently false. Congress owes it to investors to act and to change this. We need to decide if we are going to restore SIPC to what

Congress intended in the 1970s. Otherwise, we just as soon abolish it.

The status quo is a really perverse and rigged system that allows Wall Street to suck in innocent investors with these promises that someone is looking out for them to ensure that the system is set up fairly. But then when push comes to shove, SIPC can easily deny those claims for customer protection. Only the lucky few who can find their way into a court with the right kind of experience in these complex transactions has any hope of relief. Most of the victims are forced to return to work with their life savings evaporated.

Now, Mr. Harbeck in his statement suggests that the Senate really needs to act on current SIPC nominees. The first nominee, Leslie Bains, is a Managing Director at CITI and used to work at Chase Manhattan Bank and HSBC. The second nominee, John Mendez, is an equity partner at Latham and Watkins LLP. While they may be perfectly nice people, I do not think they bring the necessary track record of reform and investor protection to SIPC that is desperately needed. If they are confirmed without reforming SIPC, Ms. Bains would continue her day job, for instance, at CITI. Mr. Mendez would continue to be an equity partner at a firm that has grown into a very significant securities litigation practice, including securities class action, shareholder litigation defense, and white collar criminal matters.

I can assure you, those two nominations will not be confirmed until there is real reform at SIPC. We all saw the trouble that Sharon Bowen had getting confirmed at the CFTC. These nominees, in my opinion, are more of the same. The President needs to nominate two individuals with a track record of reform and investor protection, and we need to act on SIPC reform.

Thank you, Chairman Crapo, for holding this hearing, and to our witnesses on the panel for being here. I look forward to our discussion.

Senator CRAPO. Thank you very much, Senator Vitter.

Senator Reed, do you care to make an opening statement?

Senator REED. No.

Senator CRAPO. All right. Thank you very much.

With that, then, we will turn to our witnesses. We have with us today, as I indicated, four very solid witnesses: Mr. Stephen Harbeck, President and CEO of SIPC; Mr. Sigmund Wissner-Gross, Counselor-at-Law at Brown Rudnick; Professor J.W. Verret, Assistant Professor of Law at George Mason University Law School; and Mr. James Giddens, Partner at Hughes Hubbard and Reed.

Gentlemen, we will go in the order I have introduced you. You have probably already been informed of this. We have a little clock that tries to keep you to 5 minutes for your introductory remarks. We ask that you try to keep your introductory remarks to 5 minutes and allow us time for questioning.

With that, let us begin. Mr. Harbeck.

**STATEMENT OF STEPHEN P. HARBECK, PRESIDENT AND CEO,
SECURITIES INVESTOR PROTECTION CORPORATION**

Mr. HARBECK. Thank you, Mr. Chairman. Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, I

appreciate the opportunity to testify on the progress of the Securities Investor Protection Corporation since the beginning of the 2008 financial crisis. The Subcommittee has asked SIPC, how is SIPC protecting investors, how SIPC is responding to recent claims and customer protection, and if there are any reforms Congress should consider.

The best way to describe how SIPC protects investors, responds to claims, and operates the customer protection regime mandated by statute is to provide you with an overview of SIPC's cases in the recent history. The narrative which follows, I think, demonstrates that SIPC has protected investors as contemplated by the Securities Investor Protection Act, known as SIPA, and I believe the results achieved to date are impressive given the challenges that the SIPC has faced.

Let me turn to Lehman Brothers first. Lehman Brothers is the largest bankruptcy of any kind in history. With securities customer accounts essentially frozen and substantial customer assets at risk, SIPC initiated a customer protection proceeding on September 19, 2008. In response to the question, how does SIPC protect investors, I would note the following.

That same day, in what was called the most important bankruptcy hearing in history, Bankruptcy Judge Peck approved the transfer of 110,000 customer accounts containing \$92 billion in assets to solvent brokerage firms. Judge Peck noted that he had heard credible evidence that without the ability to transfer those accounts under SIPA, securities markets worldwide could cease to function. SIPC is proud to have been a major actor in restoring investor confidence in the securities markets at that crucial time. The actual transfer of the accounts took place in the ensuing 10 days.

Today, all Lehman Brothers customers have received 100 percent of the contents of their securities accounts and general creditors have received a distribution of 35 percent. In short, the bankruptcy processes embedded in the Securities Investor Protection Act have worked well in a severe stress case.

I would now turn to Bernard Madoff. That Ponzi scheme collapsed in December 2008, shortly after the failure of Lehman Brothers. SIPC's intervention resulted in advances to customers in the payment of administrative expenses which had results which were literally unimaginable at that time in 2008. Every customer who has left \$975,000 or less with Madoff has received all of his or her money back from the trustee. Customers with larger claims have received 48 percent of their initial investments, and that means that a claimant with a \$10 million claim against Bernard Madoff's firm has already received \$5.3 million when you take into account the addition of a distribution of customer property and advances from SIPC.

SIPC made the determination that every piece of furniture in Madoff was purchased with stolen money, so the liquidation of all assets would go into customer property and not for the payment of administrative expenses. SIPC picks up all of those administrative expenses.

In addition, substantial painstaking research by the trustee enabled the U.S. Attorney for the Southern District of New York to

create a \$4 billion forfeiture fund, which has not yet been distributed by the United States Attorney.

Finally, in terms of the large cases SIPC has had, MF Global has had absolutely stunning results. I got a call at 5:20 in the morning that customers of MF Global were in need of protection. That was the first time SIPC had ever heard of that need. After receiving authority from SIPC's Chairman within the hour, SIPC mobilized and initiated a liquidation proceeding that day. That was the eighth largest bankruptcy of any kind in history, larger in terms of assets than that of Chrysler. The results are, as I said, stunning. Each customer for both securities and commodities have received all of their assets, and general creditors have received 95 percent of their assets. In short, the process worked and it worked very well.

In terms of SIPC's financial condition, SIPC now has \$2.4 billion, which is more money than SIPC has had to expend on all liquidations in its 45-year history. We believe we have sufficient assets, but we will continue to monitor the issue as to whether our assets are sufficient.

Since December of 2012, SIPC has only had to initiate four new cases. Those new cases have cost SIPC \$7 million. I would view that as a return to normal, because the large cases that we saw were out of the ordinary.

I do urge the Committee to move on SIPC's nominees, and we can discuss that at a later time.

There are some reforms that have been suggested by the task force. Our Board did consider them. Two of them, we are looking for an appropriate legislative vehicle to put in place. They are in the nature of technical amendments. Some of the larger suggestions of the task force report were studied and the Board decided not to take action with them for larger macroeconomic reasons relating to protection by the FDIC, for example.

With respect to S. 67, my comments in my written statement stand for themselves, but I would be pleased to discuss them with you if you wish, and I would appreciate the opportunity to answer any of your questions.

Senator CRAPO. Thank you, Mr. Harbeck.

Mr. Wissner-Gross.

**STATEMENT OF SIGMUND S. WISSNER-GROSS, ESQ., SENIOR
PARTNER, BROWN RUDNICK LLP**

Mr. WISSNER-GROSS. Thank you, Mr. Chairman, and thank you for the opportunity to speak before this panel. My name is Sigmund Wissner-Gross. I am a senior partner at the law firm of Brown Rudnick LLP. I am here not on behalf of the firm, but in my individual capacity.

I had the pleasure, at times the interesting experience, of litigating the New Times SIPA proceeding during the period from 2000 through 2006. Mr. Giddens, who is here, was the trustee in that case. What I would like to do is focus my verbal remarks on some reforms that I think are needed. I will refer from my witness statement for the details of my experience in the New Times case, which, I think, illustrates many of the problems with SIPC.

At the outset, let me say that I wholeheartedly endorse the way Senator Vitter has framed this situation. There is a real problem.

The average investor has no idea that SIPC is not really the guarantor of its investments. The average investor thinks that the SIPC logo on their brokerage statement is akin to an FDIC-insured institution. It is not.

SIPA is a carefully crafted statute that was created and passed in 1970 to address circumstances at the time. There have been a host of Ponzi schemes—terrible frauds—Stanford and others beyond Madoff, that really require a fresh look and a need for reform and amendment of the statute to more appropriately address the varied circumstances that defrauded investors experience.

My case, *New Times*, was one, where we can get into it if the panel thinks it is appropriate, where all the victims had their funds misappropriated. They thought they had purchased either mutual fund shares or money market shares, all of which were never purchased, and I had to litigate for several years, ultimately succeeding, before the bankruptcy, the district court, the Second Circuit, to establish that victims who thought they had invested in fictitious or non-existent money market shares should have their claims treated as claims for securities, which at the time would have entitled them to \$500,000 of coverage. At the time, a claim for cash was only allowed \$100,000 of coverage, which, for those victims who had invested their life's savings, meant all the difference between getting some recovery or a significant recovery.

Let me turn to what I think are some specific reforms that are needed. I concur with Mr. Giddens, and I do not want to steal his thunder on this, but I concur that SIPC's maximum coverage should be increased from \$500,000 to \$1.3 million. That is a sound recommendation. That reflects the fact that the times are different and there should be increased coverage.

I also concur that there needs to be no distinction between claims for cash and claims for securities. That may have been a sensible distinction at the time of the passage of SIPA in 1970. I, unfortunately, had to litigate and win on that issue before the Second Circuit. I concur with Mr. Giddens that that distinction is a distinction without a difference. Customers who have other claims for cash or securities should be entitled to coverage in the maximum amount available.

But, I think more is needed, and I think the S. 67 does identify a number of very tangible specific reforms that are warranted.

First, I think it is clear that the SEC, which has oversight, should have more than that. The SEC, clearly, in my view, should have the right, as well as SIPC, to apply for a protective decree with respect to a SIPA member. That prerogative should not be restricted to SIPC. While I think SIPC has done many great things, and Mr. Harbeck has identified some of the more notable achievements, the fact of the matter is that, in my experience, SIPC at times has taken a very narrow and unduly restrictive approach toward investor protection. SIPC does have a reputation in the legal marketplace as being very litigious, sometimes on an unwarranted basis, sometimes to try to establish a point of law when it should have exhibited pragmatism and effort to focus more on investor protection. I think it would be prudent to allow the SEC, which has oversight responsibility, to have the ability to appoint or seek to in-

tervene in terms of a SIPA proceeding. The Stanford matter, that actually would have solved that situation.

In addition, while I do not concur that trustees should be limited to one case, as proposed in S. 67, I think there is a significant issue about SIPC using the same trustees time and time again. While I respect Hughes Hubbard a great deal as a firm, my experience was that, in my litigation with them, they invariably looked to SIPC to guide them on particularly significant determinations and approaches and policies in the case, and my sense was that they always acted in tandem, but it was always the trustee acting essentially at the direction of SIPC. I think there needs to be some reform so that the trustee will, in fact, be independent and do the right thing.

Finally, with respect to the investor, I appreciate that there is a lively debate about whether the rules proposed in S. 67 in terms of net equity statements, of whether that should be a binding approach or another approach should apply. I think that there does need to be reform so that customer protection, it is advanced so that you do have with these Ponzi schemes a whole variety of ways in which customers are defrauded. In my experience, it is often the case that the statute does not apply on all foras. So, there needs to be a reform to make sure that people who have lost money, were innocent victims who, frankly, do not fit within the specific definitions or labels of the SIPA statute, are protected. I think S. 67 is an excellent start in that regard.

Senator CRAPO. Thank you, Mr. Wissner-Gross.

Professor Verret.

**STATEMENT OF J.W. VERRET, ASSISTANT PROFESSOR OF LAW,
GEORGE MASON UNIVERSITY SCHOOL OF LAW, AND SENIOR
SCHOLAR, MERCATUS CENTER AT GEORGE MASON UNIVERSITY**

Mr. VERRET. Chairman Crapo and Ranking Member Warner, I appreciate the opportunity to join you today to talk about this important issue. My name is J.W. Verret. As you mentioned, I teach at George Mason Law School, corporate and securities and banking law. I also serve as a Senior Scholar at the Mercatus Center, and until recently, I was Chief Economist and Senior Counsel for Chairman Hensarling at House Financial Services, where I first started to spend a significant amount of time on this issue.

The explosive growth in federally backed loan and guarantee programs has been an appropriate focus of congressional oversight in recent years. OMB estimates the Federal Government supports over \$3 trillion in loans and guarantees. These loans and guarantees are often shrouded by indirect Government support and unreasonable assumptions in Government accounting practices.

I submit that SIPC's provision of securities custody insurance should be an appropriate part of that conversation. Government officials appoint SIPC Directors and SIPC enjoys access to a \$2.5 billion line of credit with the Treasury Department. Some may argue that statutory language that SIPC, quote, "SIPC shall not be an agency or establishment of the United States Government" suggests otherwise, and we certainly all recall how similar statutory

language in the GSEs proved entirely meaningless and nonbinding when those entities were placed under Federal conservatorship.

Today, I will argue that privatization of SIPC's custodial insurance function is the best solution to protect American taxpayers and also is the best solution to insert a level of market discipline into SIPC's risk pricing for coverage. It will add an element of risk pricing, I think, under a private scheme. I will identify some unexplored solutions for victims of Ponzi schemes. And though I argue that privatization is certainly the first best solution, I am glad to constructively engage in this Committee's examination of additional reforms to SIPC.

Most broker-dealers and members of national exchanges are required by statute to be members of SIPC, and SIPC is funded by assessments on its membership. SIPC thereby enjoys a statutory monopoly in the provision of securities custody insurance underneath the ceiling of its coverage.

Now, some of my fellow panelists may argue that SIPC serves an important role as a specialized liquidator or receiver of broker-dealers and in overseeing that process. Now, assuming that argument is true for the sake of argument, it remains a tall leap of logic to further contend that a Government monopoly in the provision of securities custody insurance is thereby warranted.

SIPC's Board is currently composed of both private sector and Government members. I submit—I will reiterate that privatization of SIPC's insurance function is the first best solution to the problems posed by the current structure of SIPC, and we might begin by lowering the ceiling of that coverage, where I would disagree with a couple of my fellow panelists. I find it hard to accept that a market failure necessitates a Government monopoly in this space, particularly in the current information era, an era very different from the 1970s. In fact, there are underwriters at Lloyd's that will sell excess of SIPC coverage for the portion of that market not crowded out by SIPC.

In the absence of full privatization, the public-private composition of SIPC's Board should not be viewed as a second-best option. It would be better as a second-best option to officially recognize SIPC for the Government entity that it is, remove the private sector Board members, establish a similar level of congressional accountability to that required of other Government agencies, impose a term limit on its Chief Executive Officer, as is the case among SEC Commissioners, and also increase the level of the SEC's oversight of this entity.

The controversy and subsequent litigation between the SEC and SIPC regarding the Stanford Ponzi scheme and issues with respect to the Madoff victim claims also suggest a warning label should be provided describing SIPC coverage that, quote, "SIPC coverage only applies under limited circumstances and SIPC reserves the right to deny claims despite reasonable expectations of coverage."

SIPC won the Stanford litigation because of a regrettable stipulation of fact by the SEC. In the Madoff litigation, SIPC utilized an aggressive valuation methodology from among a range of methods it had used in prior cases. My impression of both of those cases, in my professional opinion as a professor of securities law, is that they were close calls that might have come out either way. But it

is also, nevertheless, very crystal clear to me that SIPC's aggressive litigation position was designed to minimize claims to a fund unprepared for them, which suggests a clear conflict of interest for the receivers, liquidators hired by SIPC and SIPC itself in the administration of this fund.

I am not here today to relitigate those cases or to endorse particular legislation. I sympathize with the victims. I recognize they have been subjected to aggressive posturing by SIPC. But, I worry about action that might further entrench SIPC's monopoly. I would suggest instead looking at undistributed funds in the SEC's Fair Funds, undistributed funds that often sits in the CFPB's settlement awards, or banking settlement agreements with DOJ and HUD. There is a significant stash of money this Committee might consider to make those victims whole.

I thank you for the opportunity to testify and I would just reiterate that the design of SIPA in the 1970s may have made sense in the 1970s. There were lots of ideas from the 1970s that made sense at the time that will not necessarily stand the test of time, like bell bottoms and the lava lamp. I think the design of SIPC from that era does not stand the test of time and needs to be reconsidered 40 years later. So, I thank you for the chance to testify.

Senator CRAPO. Thank you, Professor Verret.

Mr. Giddens.

STATEMENT OF JAMES W. GIDDENS, PARTNER, HUGHES HUBBARD & REED LLP, AND TRUSTEE, SIPA LIQUIDATIONS OF LEHMAN BROTHERS INC. AND MF GLOBAL INC.

Mr. GIDDENS. Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, thank you for inviting me to testify.

My testimony today is based on my experience with SIPA over the past 45 years, most recently as trustee for the Lehman and MF Global liquidations. In my experience, SIPA has succeeded in protecting customers in these cases, the two largest broker-dealer failures in history and the greatest challenges to the statute.

In Lehman and MF Global, the 110,000 and 36,000 customers, respectively, received 100 percent of their property. The customers of these failed entities included mom-and-pop investors, farmers and ranchers from all walks of life, from every jurisdiction in the country.

With both Lehman and MF Global, we closely and systematically consulted not only with the SEC, but the CFTC, the Federal Reserve, and multiple congressional committees. We have appreciated their guidance. In Lehman, I was also grateful to have the support of Mr. Wissner-Gross, who publicly supported my and SIPC's position before the United States Supreme Court, seeking a review of a decision of the Second Circuit.

However, I will say that, as with any statute, especially one implemented decades ago, I believe there is room for modernization and improvement. Consistent with my SIPA duty to advance customer protection, I would like to provide three considerations that may merit further study and, of course, input from regulators, industry experts, and the public. A more complete discussion of these and 26 other recommendations is included in my written testimony, which incorporates the detailed public submissions of the

SIPC Modernization Task Force as well as my own Lehman and MF Global reports and prior testimony before the Senate Banking and other congressional committees.

First, as proposed by the task force, I strongly support increasing SIPC's maximum coverage from \$500,000 to \$1.3 million. That simply corresponds to an increase through inflation from what was originally proposed in the 1970s. Future coverage limits should also be tied to inflation. This would immediately and significantly increase the protection for customers, especially those who are not large or professional investors.

Second, also in the task force report, I propose eliminating the distinction between claims for cash and claims for securities. This reform would resolve the potential disparate treatment of customers and increase the amount of customer protection available.

Finally, I believe consideration should also be given to expanding the borrowing and guarantee authority available to SIPC trustees and other liquidators. The SIPC fund has met the demands of all previous SIPA liquidations. However, the Lehman liquidation, in particular, demonstrated that just one failure of a SIPC member broker-dealer could require at least a temporary availability of much more substantial sums. The ability to quickly and efficiently return customer property in the early days of a liquidation would be enhanced if the borrowing limit were increased.

In concluding, I believe that the SIPA statute has succeeded in protecting customers of SIPC member brokerage firms. I also believe the shared goal of continuing and strengthening protection of investors, particularly nonprofessional investors, can be achieved with improvements to the statute and related laws.

Thank you, Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, for the opportunity to testify before you.

Senator CRAPO. Thank you, Mr. Giddens.

I will start out with you, Mr. Harbeck, with some questions, and my first question relates to basically the appropriate amount for the SIPC fund. I think you indicated in your testimony it is currently at \$2.4 billion, and I understand that the SIPC Board has set a target balance of \$2.5 billion, which matches the line of credit that SIPC has with the U.S. Treasury. How did you determine that \$2.5 billion was the appropriate amount, and given some of the other testimony that we have heard today, is \$2.5 billion the appropriate amount?

Mr. HARBECK. Mr. Chairman, I can assure you that a subtext in every single SIPC Board meeting is whether SIPC has sufficient resources. In 2008, when we had \$1.6 billion, we realized when the Madoff case fell in December of 2008 that we should turn on the assessment spigot. We did so. We have completed all of the functions required in Lehman Brothers and MF Global and Madoff with an expenditure of approximately \$1.8 billion to date. But, we have at the same time increased our resources from the 1.6 that we had in 2008 to 2.4.

I know, based on past experience, that whenever we reach a plateau or a target, the Board of Directors takes a long hard look, and since that was 7 years ago when they set that target, that they will do so again.

We currently have assessments on all SIPC members of one-quarter of 1 percent of net operating revenues. That generates approximately \$400 million a year. SIPC's resources currently, the existing \$2.4 billion that we have, is sufficient to have satisfied all obligations in all cases in our history. With that, we are always open to other ways to finance in an emergency or to increase the fund if it becomes necessary.

Senator CRAPO. Well, thank you, Mr. Harbeck.

For Mr. Wissner-Gross and Mr. Giddens, I appreciate your perspectives on how SIPC responded to the claims because of the financial trouble and failure of Lehman Brothers, Madoff, MF Global, Stanford, and New Times. What are the main take-aways about how SIPC responds to claims when a member firm fails because of fraud as opposed to other financial reasons?

Mr. WISSNER-GROSS. If I could address that first, I do think, again, I think SIPC has done a fine job in many proceedings, but the ones that Mr. Harbeck has identified are three of the 328 SIPA proceedings that it has handled since 1970, and my experience is primarily focused on New Times, so let me address that.

I found that I actually had to fight at every step of the way to secure coverage in that case. It was not an atypical fraud claim. The Ponzi operator, a guy named Mr. Goren, had put several hundred elderly investors into a program where he basically embezzled their funds, gave them brokerage statements that confirmed that they had purchased mutual funds and money market shares, but had not, in fact, done that.

My recollection is initially that SIPC refused to acknowledge customer status for any of them. So, my first job was I had to fight both to try to get the SEC as well as the bankruptcy judge involved to be supportive of the fact that there should be customer claim or customer status acknowledged. We ultimately, between the judge and SEC, I think, twisted SIPC's arm to—through Mr. Giddens, the trustee—to acknowledge that status.

Having accomplished that, then every individual customer had to fight, in my view, with the SIPC trustee to acknowledge and determine the fact of whether they had invested funds, the amount of funds invested, and it was a very arduous process. We represented quite a number of those defrauded investors who were innocent beyond belief, and they included Holocaust survivors, retirees, and so forth, not atypical of defrauded investors in these schemes. Looking back on it, I would have preferred that there be more of a presumption of a desire to protect them in the first instance rather than to have those investors be put through the grill in terms of establishing coverage.

I highlighted one particular investor in my remarks, where a woman named Mary Lee Stafford, who lost—who invested \$75,000 and had it embezzled as a result of a purchase of money market shares that were never purchased. Single mother, cancer victim. This was all the money she had, and SIPC and the trustee denied coverage. I fought it. The bankruptcy judge agreed with them. I appealed it to the district court. I got it reversed. And they should have, frankly, said, fine, let her get her money. It was \$69,000 out of pocket. That was all of her life's savings. Instead, they appealed it to the Second Circuit, which was their prerogative, and they

were successful, and in the end, she did not get anything in terms of coverage.

To me, frankly, that was a shame, because I think this was in the gray area of coverage. She clearly could have been acknowledged as a claimant. I would like to see those kinds of things not happen in the future.

Senator CRAPO. Thank you.

And, Mr. Giddens, my time has run out, but if you could briefly respond, I would appreciate that.

Mr. GIDDENS. Yes. I have a different take on New Times. In New Times, there were about 1,000 securities customers. Ninety-nine-point-nine percent of all those customers received all that they claimed on their claim forms and they were paid. SIPC advanced millions of dollars. There were only, I think, two claimants in the entire case who exceeded the limits of SIPC participation. And I am sympathetic to anyone who loses money in a Ponzi scheme and the like, but one of the difficulties here was—and it was a complicated case—that there was also a parallel SEC receivership going on with respect—at the same time as the SIPC proceedings.

And from the 1970s on, one of the principles established in the SIPA statute was, from the beginning, that if you loaned money to the broker-dealer, that if you were a subordinated lender or otherwise a lender or had promissory notes, you were treated as a lender as opposed to a securities customer who deposited cash in securities.

In the New Times case, the malefactor in that case persuaded many of the individuals—fraudulently—to purchase promissory notes from him individually, and these were not customer transactions. In that case, we also, to assist investors, did a substantive consolidation of certain entities because under bankruptcy principles, there was so much interrelationship of transactions and the like.

So, overall, my view is, yes, there always—in any SIPC case, you have to apply the statute, and yes, based on precedence and the like, I think we applied the law correctly and I think the overall result was that virtually 99 percent of all those claimants received all that they claimed in New Times.

Senator CRAPO. Thank you very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and gentlemen, thank you all for your testimony.

Mr. Harbeck, it strikes me that they call you at 5:20 in the morning after the other folks have failed, *i.e.*, after regulators, and others who were supposed to be governing the conduct of these broker-dealers, failed. So, your role cannot be isolated from the operations of the SEC and other agencies. So, to what extent do you have any sort of insight into the broker-dealer activities that might—or any influence over their behaviors that might give you the tools to prevent rather than just respond to these crises?

Mr. HARBECK. By design, SIPC is not a regulator. The regulatory regime in the United States has a Federal regulator, state regulators, self regulators, and Congress when it established SIPC made sure that we were not another regulator.

That said, we work very, very closely with the SEC. The MF Global case did, in fact, come up suddenly, but we work hand-in-glove with the SEC. Even throughout the recent past when the Securities and Exchange Commission was litigating with SIPC, the relationship on the staff was professional and I can tell you that right now, the relationship between the SEC and SIPC is at a high point. Chairman Mary Jo White has met with our Board of Directors. She is the first SEC Chairperson to do so. We hope to have other members of the Commission meet with us and meet with our Board of Directors to share common concerns. We work hand-in-glove with the SEC. That is the answer to it.

Senator REED. Do you think the SEC has the resources or the capacity to thoroughly inspect broker-dealers? As Senator Warner mentioned in his opening remarks, we are still at a very low rate of inspections on a regular basis of broker-dealers.

Mr. HARBECK. Well, I believe Senator Warner mentioned investment advisors, which are not covered by SIPC.

Senator REED. Right.

Mr. HARBECK. But, frequently, the investment advisors custody their securities at SIPC members. In fact, that is what they are supposed to do. I think it would be an excellent idea to increase the resources available for inspecting those because that is a possible way to stop fraud *ab initio*.

Senator REED. Mr. Giddens, you have been a trustee in several cases, and in your testimony, you suggest that more pre-liquidation disaster planning could be helpful. Could you elaborate on that?

Mr. GIDDENS. Yes. The Lehman case was done on a very *ad hoc* basis and under extraordinary circumstances, and there was not sufficient time to involve SIPC or perhaps the SEC and the like in the process. A great deal of the activity was dictated by the Treasury Department and the Federal Reserve, all attempting to avert a worldwide financial crisis. There was not sufficient time or planning to fully understand the implications of the transfers and the like.

Contrary to the public assumption, Barclays did not acquire all the securities accounts of Lehman. They left behind accounts—they could pick and choose assets. They did not assume all the liabilities. That is not to criticize those who structured that deal. It was—Barclays at the time was the only prospective bidder. But, essentially, it took years to unravel the intricacies and complications of Lehman through 76 proceedings around the world.

There is an attempt by requiring large firms to prepare so-called living wills to more systematically sort of determine where assets are, how assets will be obtained, and the like. As I say, in Lehman, just by way of example, the British Prime Minister claimed that \$8 billion was improperly taken from the U.K. and transferred back to the United States. So, that turned out not to be correct and they later dropped that sort of thing, but there was such confusion and misunderstanding about how the system operated, so that preplanning involving those who would be involved in a liquidation is very, very important.

It is also very important to identify the categories of all the claimants, not just securities claimants, but unsecured creditors

and the like. That would help enormously in any liquidation if you really had a clearer picture of what you are trying to achieve.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Senator CRAPO. Thank you, Senator Reed.

I am going to just ask one more quick question before I turn both the gavel and the time over to Senator Vitter, and that is for Professor Verret, I am interested in your argument about privatization. Could you just briefly tell me how you envision that would work?

Mr. VERRET. Sure. I think that, you know, first, I think there would be a substantial transition period, recognizing the fact that members have been assessed for the fund that is currently there with the expectation of coverage. So, you would have to work through some transition issues. I think you would begin by lowering the ceiling of coverage. But, I think part of the benefit you would get there is for whatever is not crowded out by SIPC coverage, I think you would see private sector operators doing risk-based premiums, risk-based pricing. That would go along with some of the issues we have talked about today.

I mean, I would expect that a private-based provider would set your risk-based premium based on the adequacy of your resolution planning, your living will. I think that one of the problems with the current structure is that not only is there a Government subsidy through the Treasury's lending to all firms provided with coverage, but there is internal subsidization. The best actors subsidize the worst actors with an assessment that is homogenous, you know, homogenous assessment. So, I think that, for instance, publicly traded broker-dealers that have Section 404 internal controls are a very different situation from nonpublic broker-dealers, and so you would expect the premium to be very different there.

So, in short, to answer your question, I think there would be a transition, but I think—and I think you would probably begin by lowering the ceiling of coverage. But I think that you would see some risk-based pricing, some market discipline inserted into that process. That would be very helpful with a lot of the issues we have been describing.

Senator CRAPO. Well, thank you very much, and as you can see, it is a busy morning and I, too, am going to be called away to another obligation. But, I know this is a critical issue to Senator Vitter, and at this point, I am going to turn both the gavel and the time over to you, Senator Vitter. Thank you.

Senator VITTER. [Presiding.] Thank you, Senator Crapo. Thanks for calling and sharing this hearing. Thanks to all of you for being here.

Mr. WISSNER-GROSS, I want to step back and sort of start with the big picture in terms of some of the comments you suggested. Under the current system, we have SIPC, we have this SIPC "Good Housekeeping Seal" logo, correct?

Mr. WISSNER-GROSS. Yes.

Senator VITTER. And that is very widely used by SIPC members. I mean, they put it on all of their Web sites—

Mr. WISSNER-GROSS. On every statement.

Senator VITTER. Yes, every statement, every Web site, every piece of literature, every entry door, basically, because it is that sort of “Good Housekeeping Seal” logo similar to FDIC, would you agree with that?

Mr. WISSNER-GROSS. Yes, Senator.

Senator VITTER. And yet the reality is, say, compared to FDIC, it is fundamentally different and it is fundamentally less protection, would you also agree with that?

Mr. WISSNER-GROSS. Yes, Senator.

Senator VITTER. So, it seems to me the big picture is that the average customer is sort of actively being misled, as given this “Good Housekeeping Seal,” member firms are actively using that for their benefit in the market, and it is not there when customers need it in many cases. In fact, it is most uncertain, it seems to me—correct me if you think this is wrong—but it is most uncertain in many outright cases of fraud versus simply failure, and it seems to me that is particularly ironic, would you agree with that?

Mr. WISSNER-GROSS. Well, I am not sure I am going to go all the way with you on that comment. I do think that fraudsters will typically use the SIPC logo as a means of trying to lull their investors into thinking that it has SIPC protection. I do not know whether I am prepared to go with you all the way to say it is being used by the well-established brokerage firms to somehow facilitate a fraud. But I do concur—

Senator VITTER. No, no, I did not say that or did not mean to suggest that. What I am saying is, when push comes to shove, often, the victims who have most difficulty being made whole are victims of outright fraud versus other cases—

Mr. WISSNER-GROSS. That is—

Senator VITTER.—of market failure.

Mr. WISSNER-GROSS. That is correct.

Senator VITTER. And it seems to me that is particularly ironic that it is least certain in many cases of outright fraud versus market failure.

Mr. WISSNER-GROSS. I will agree with you.

Senator VITTER. That is all I was trying to say.

Now, it seems to me we should recognize this fundamental disconnect and correct it in some way, either make that “Good Housekeeping Seal” what it purports to be, or take it off everybody’s doors and stop the complete misrepresentation.

Mr. WISSNER-GROSS. Well, I will agree that if it is going to be there, there should be an appropriate disclaimer—

Senator VITTER. Right.

Mr. WISSNER-GROSS.—so that people understand what is at issue. But, I think, more to the point, as I said in my opening remarks, I concur that you have properly framed the issue and I think the proposed legislation identifies several ways in which we can hopefully begin to rectify the problem.

Senator VITTER. Correct. Is not one of the big differences—I keep using this analogy with FDIC because I think that is how consumers read that “Good Housekeeping Seal”—is not one big difference that SIPC has industry members who are clearly active, ongoing industry members who have vested interests in SIPC members and private sector industry partners?

Mr. WISSNER-GROSS. I will agree with you there, as well.

Senator VITTER. Do you think that poses a potential conflict?

Mr. WISSNER-GROSS. Yes, Senator. I think—and there are various ways in which that could be addressed, particularly if you have a board that is truly independent.

Senator VITTER. Correct. Do you have any particular thoughts about the best way to erase that potential conflict?

Mr. WISSNER-GROSS. Well, the same broker-dealers are regulated by the SEC, and typically when there is fraud, it is identified by the SEC. I do not have specific recommendations, but I think that you have correctly framed the problem. I think there has to be a better path to ensuring that SIPC, true to its mandate, is truly independent, truly looking out for the best interest of investors, and truly able to protect those interests.

Senator VITTER. And would one partial or whole solution be giving SEC more outright authority over SIPC—

Mr. WISSNER-GROSS. Yes. I—

Senator VITTER.—in certain cases, including fraud?

Mr. WISSNER-GROSS. I 100 percent agree with you, and in fact, I endorse the proposal allowing the SEC to be able to initiate SIPA proceedings. And, clearly, they have already a statutory right of oversight. I think it would be in the best interest of everybody to have the SEC, which can shut down firms after identifying fraud, also being much more intimately involved with the day-to-day operations and enforcement of those situations.

Senator VITTER. Right. Mr. Harbeck, obviously, I am very concerned about the Stanford case. I represent a lot of Stanford investors. To date, how many of those Stanford investors have gotten any recovery from SIPC?

Mr. HARBECK. None, sir, as a result of the case of SEC v. SIPC—

Senator VITTER. OK.

Mr. HARBECK.—where the court stated that the Stanford victims did not fall under the statutory program that we administer.

Senator VITTER. OK. So, I just want to make clear, we are talking about these other cases, 99 percent, great majority, blah, blah, blah. Stanford, just factual basis—I want to be clear—everybody has been shut out of recovery.

Mr. HARBECK. That is correct.

Senator VITTER. OK.

Mr. HARBECK. SIPC—

Senator VITTER. Now, let us walk through SIPC's arguments for that, because as I have followed them, they are changing. At the district court—let me just ask you if you can put in layman's terms, not hyper-technical terms, but in layman's terms, the grounds for SIPC not standing behind those investors.

Mr. HARBECK. Senator, as you know, the Securities Investor Protection Act is a complex statute. But if you would try to reduce it to one sentence in terms of what is protected and what is not protected, that sentence would be as follows: SIPC protects the custody function that brokerage firms perform for their customers and only the custody function. And in the Stanford case, it was our consistent view for the 2 years prior to that lawsuit that all of the customers that the SEC knew of had their certificates of deposit, or

they were in the custody of another entity that had their certificates of deposit, or they were book entry. SIPC——

Senator VITTER. You are basically talking about Antiguan CDs?

Mr. HARBECK. That is correct.

Senator VITTER. OK.

Mr. HARBECK. All money went directly to the Stanford International Bank of Antigua, or a bank account owned by the Stanford International Bank of Antigua. The SIPC member brokerage firm was not holding any assets, nor was it supposed to be, for those customers.

Senator VITTER. Now, Mr. Harbeck, that is the argument that you all made in district court. You changed the argument when it got to appeal. I will get to that in a minute. But, let us start with the district court. Is it not correct that those customers were issued these Antiguan CDs and there was never money in that Antiguan bank backing them up? That was a complete fraud.

Mr. HARBECK. There was absolute fraud *ab initio*. However——

Senator VITTER. Was there money in the Antiguan bank backing up those CDs?

Mr. HARBECK. There is some. There is an independent entity or receiver in the Stanford—in Antigua that is in charge of restoring those customers to the extent he can.

Senator VITTER. I do not know what that means. Was there money in that Antiguan bank backing up those CDs or not?

Mr. HARBECK. Senator, we do not have investigatory authority. Certainly, we do not have it overseas.

Senator VITTER. There has been forensic accounting that has shown that there was no money in that Antiguan bank backing up the CDs. Do you agree with that, because that is the record?

Mr. HARBECK. I do not believe it is the record in the case that we litigated. I will assume it is true.

Senator VITTER. You will assume it is true?

Mr. HARBECK. For purposes of discussion, of course.

Senator VITTER. So, in the district court, the argument is, well, this was an investment in a foreign bank that is not covered under the SIPC law, under SIPA, but the money never reached the foreign bank. The CDs were issued. There was no cash backing them up. You do not think that is a problem with your argument?

Mr. HARBECK. No, I do not, because I—I do not agree with you in this regard. As far as I know and as far as the SEC stated, all monies either went to the Stanford International Bank or went to a bank account under its control.

Senator VITTER. Well, you are talking about an SEC statement of facts submitted to the district court that was incorrect, that is contrary to the forensic accounting. Are you aware of that?

Mr. HARBECK. I am aware that someone has submitted an affidavit saying the money did not go to Antigua. The SEC, when we asked them about that, did say that the money went to an American bank account owned by the Stanford International Bank of Antigua.

Senator VITTER. An American bank account?

Mr. HARBECK. Correct.

Senator VITTER. OK. So, Mr. Harbeck, I think you are aware of what I just laid out, because when the case went to circuit court, you all changed your argument completely.

Mr. HARBECK. That is not correct, sir.

Senator VITTER. Well, in the circuit court, your primary argument was that somehow this was a loan from the customers to the broker-dealers and there is a specific exclusion to cover that. Was that not a significant argument—

Mr. HARBECK. That was—

Senator VITTER.—that SIPC made in—

Mr. HARBECK. That was a secondary argument that we made in both courts, sir.

Senator VITTER. And when these customers were buying CDs, you think they were loaning the broker-dealers money or investing in the broker-dealers?

Mr. HARBECK. That is not what the court said. The court said that—

Senator VITTER. I am asking what you said in terms of that particular argument. You made that argument. So, do you think it was a fair characterization in making that argument that in buying CDs, these customers were loaning the broker-dealers money?

Mr. HARBECK. The SEC argued that if you substantively consolidated these entities, then a SIPC member firm was holding assets for the debtor. Substantive consolidation never took place, number one. But what the court said is that if it did, then people would be—instead of lending money to the Stanford International Bank, which is what a CD is, it would be lending money to the brokerage firm and that is not protected by statute.

Senator VITTER. Right, except they had a CD and they never agreed to lend money to the brokerage firm. The brokerage firm stole the money, kept the money. That is cash. That is covered under SIPA. Cash is covered under SIPA. CD is covered under SIPA. And yet you all concocted this ridiculous theory that, no, it was not a CD, even though the customer had a CD piece of paper. It was not cash, even though that is what the broker-dealer stole and diverted. It was somehow a loan to the broker-dealer, which obviously the customer never agreed to. I mean, do you not—

Mr. HARBECK. Senator, your statement does not comport with the stipulated facts.

Senator VITTER. Well, the stipulated facts were wrong and have been disproved by the forensic accountant.

Mr. HARBECK. I disagree.

Senator VITTER. OK. Well, I think the broader point here is that I do not think an entity like FDIC would have spent tens of millions of dollars to do back-somersaults to make those sorts of arguments. I think only an entity dominated by industry members would have done those back-somersaults and spent tens of millions of dollars in legal fees to make those sorts of arguments. I guess that is my broader point.

Let me go to Mr. Giddens, and I have another concern about the trustee relationship. And, Mr. Giddens, I acknowledge you are a very competent person in the roles you have played and I do not question your competence or your integrity. I do question the conflict of interest between people who are named over and over and

over as trustees, make a lot of money doing it, and that person's role protecting the investors, and I think that is a built-in and serious conflict, that practice.

So, with that in mind, let me ask you, how many times have you and your firm—or your firm—acted as SIPC matter trustee?

Mr. GIDDENS. I believe in five or six cases out of the 300 cases over 45 years.

Senator VITTER. So, five or six cases?

Mr. GIDDENS. Yes.

Senator VITTER. And roughly how much money do you think you and your firm have made doing that?

Mr. GIDDENS. I do not, off the top of my head, know. What I would say is, one, I have never applied for compensation for myself as trustee in a personal capacity. The law firm, of which I am a partner, has to apply to the bankruptcy court for compensation. That compensation is on notice to all creditors, and after a hearing, the compensation has to be approved by a bankruptcy court and a bankruptcy judge. The cumulative amount of compensation, I do not know. In terms of the—

Senator VITTER. Can you give us a sense of proportion, a ballpark figure?

Mr. GIDDENS. I really—

Senator VITTER. Was it over a million dollars in each case?

Mr. GIDDENS. No. It was less than a million in some cases and over several million dollars in other cases. Again, the compensation is governed by Bankruptcy Code requirements, where the compensation should be based on results achieved. There is also a public interest discount.

In terms of—if I may just comment on—I think you raise a legitimate question. On the conflict of interest, I would point out that, for example, in Lehman and MF Global, we have had adversary proceedings against principal firms on Wall Street, major, major issues involving billions of dollars in firms such as JP Morgan, Goldman Sachs, Morgan Stanley, and the like. So, it is not correct that there is a bias toward large Wall Street institutions. They equally have disputes with SIPC and the SEC about what is covered, for example, repo transactions and things of that sort.

Senator VITTER. Well, just to clarify, I was not talking about a bias there. I was talking about a bias of the trustee toward SIPC—

Mr. GIDDENS. Well—

Senator VITTER.—because SIPC hires a trustee, in some cases, over and over. That is a major book of business. That is a major source of compensation for the firm. So, that is the bias I was talking about.

Just to give you an example, you were not named trustee in Stanford. If you were, and if you had decided matters in terms of customer status and compensation contrary to the way SIPC has fought—SIPC has fought the SEC, SIPC has gone to court, SIPC has gone to circuit court, SIPC has spent tens of millions of dollars on this—do you think you would be a prime candidate to be hired as a trustee the next time?

Mr. GIDDENS. Umm—I am not sure I fully understand the question. If the—

Senator VITTER. Let me restate it.

Mr. GIDDENS. If you are saying, hypothetically—

Senator VITTER. If you were the trustee in Stanford, and if you had disagreed with SIPC on this fundamental question of customer status and right to recovery—

Mr. GIDDENS. Well—

Senator VITTER.—which SIPC has fought tooth and nail to an extraordinary extent—SEC told them to act otherwise. SIPC fought the SEC. SIPC went to court. SIPC went to circuit court. SIPC spent millions of dollars fighting this, which obviously come out of the assets of the fraudster. Do you think, if you had fundamentally disagreed with SIPC on that, do you think you would be a prime candidate to be named a trustee in the next big SIPC case?

Mr. GIDDENS. The answer is, I do not know. The answer is, if I—the confusing part is to be appointed a trustee or being suggested as a trustee by SIPC to the district court, which has to appoint you, that would mean that SIPC had started a SIPC liquidation of Stanford. And if I were the trustee, I would look at the statute. That would be my job. Obviously, I would discuss it with SIPC, the SEC, and others involved and try to reach a fair decision. I am sympathetic to any group of people who are defrauded, and I think whether it is a SIPC trustee or an independent trustee, you ought to use all your resources to try to find ways for recovery. There are other avenues, maybe not successful, other than simply relying on the SIPC fund.

Senator VITTER. Right. Well, we can just disagree about this. I will answer my own question. I think it is obvious that you would not be on the short list by SIPC the next time, and that is the conflict I am talking about, similar to the conflict in terms of industry members of SIPC.

Let me end on that note. First of all, thank you all very much for your testimony and your participation. I think this has been an important and productive discussion.

I am determined that this discussion moves to action in terms of appropriate reform, and I am equally determined that there will be no confirmation of outstanding proposed SIPC members unless and until that reform happens. So, I look forward to all of that.

Thank you very much. The hearing is adjourned.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF STEPHEN P. HARBECK

PRESIDENT AND CEO

SECURITIES INVESTOR PROTECTION CORPORATION

SEPTEMBER 30, 2015

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee: Thank you for the opportunity to brief you on the progress the Securities Investor Protection Corporation (SIPC) has made since the beginning of the 2008 financial crisis.

The Subcommittee has asked how SIPC is protecting investors, how SIPC is responding to recent claims and customer protection, and if there are any reforms Congress should consider. The best way to describe how SIPC protects investors, responds to claims, and operates the customer protection regime mandated by statute is to provide you with an overview of SIPC's performance since the beginning of the 2008 financial crisis, which includes the most significant cases in SIPC's history. Potential reforms will be addressed at the end of this statement. The narrative which follows demonstrates that SIPC has protected investors as contemplated by the Securities Investor Protection Act (SIPA). I believe the results achieved to date are impressive, given the scope of the challenges presented.

How is SIPC protecting investors and how has it responded to recent claims and customer protection?

Lehman Brothers Inc.

Lehman Brothers is the largest bankruptcy proceeding of any kind in history. With securities customers' accounts essentially frozen and substantial customer assets at risk, SIPC initiated a customer protection proceeding on September 19, 2008. That same day, in what has been called the most important bankruptcy hearing in history, Bankruptcy Judge James Peck approved the transfer of 110,000 customer accounts containing \$92 billion in assets to solvent brokerage firms. Judge Peck noted that he had heard credible evidence that without the ability to transfer those accounts under SIPA, securities markets worldwide could cease to function. SIPC is proud to have been a major actor in restoring investor confidence in the securities markets at that time. The actual transfer of those accounts took place over the next 10 days.

The SIPA trustee proceeded to close the complex, worldwide business operations of Lehman. Among the highlights of that work was a victory for investors in the Supreme Court of the United Kingdom that resulted in additional assets being set aside for customers.

Today: All Lehman Brothers customers have received a 100 percent distribution, and general unsecured creditors in that case have already received 35 percent of their claims.

In short, the bankruptcy processes imbedded in SIPA have worked well in a severe stress case.

Bernard L. Madoff Investment Securities LLC

Bernard Madoff's Ponzi Scheme collapsed in December 2008. SIPC's intervention resulted in advances to customers and the payment of administrative expenses with results that were unimaginable at the time.

Every customer who left \$975,000 or less with Madoff has received all of his, her, or its money back from the trustee. Customers with larger claims have received 48.08 percent of their initial investment, meaning that a claimant who left \$10 million with Madoff has already received \$5.3 million from the trustee, including SIPC advances. Further, SIPC took the position that every single asset of the Madoff firm was purchased with stolen money, so all recoveries, of any nature, should go into the "fund of customer property." SIPC thus pays every cent of the administrative expenses in that case.

In addition, based substantially upon painstaking research by the trustee's staff and paid for by SIPC, the United States Attorney for the Southern District of New York has amassed a sizable sum which comprises a forfeiture fund. Distribution of that fund, which is in excess of \$4 billion, has not yet begun.

The SIPA trustee is engaged in extensive litigation which, if successful, will benefit those who have not yet received all of their net funds invested with Madoff.

In summary, the trustee has maximized the returns to victims given the tools available to him. He has worked in cooperation with regulatory and criminal authorities, and will continue to do so. There will be additional distributions as more funds are added to the fund of "customer property."

MF Global Inc.

On October 31, 2011, the SEC notified me at 5:20 in the morning that the customers of MF Global were in need of the protections of the SIPA statute. After receiving authority from SIPC's Chairman within the hour, the SIPC staff mobilized and initiated a liquidation proceeding for that firm that afternoon. This is the eighth largest bankruptcy in history.

The results in the MF Global case are stunning. All securities and commodities customers have been paid in full. Last week, the trustee commenced the final distribution to general creditors, who will receive 95 cents on the dollar. Bankruptcy Judge Martin Glenn recently stated that "At the outset of the case, nobody thought that customers would recover everything they lost."

The trustee and SIPC litigated a number of issues interpreting SIPA, some of which were issues of first impression, and have been uniformly successful.

In short, the process worked, and worked well.

SIPC's Financial Condition

In January 2009 some Members of the Committee expressed concern about the financial condition of SIPC. I am pleased to report that SIPC has performed all of its statutory duties during the financial crisis, and that it continues to be in sound financial condition. In December 2008, the SIPC Fund stood at \$1.7 billion. Immediately upon the commencement of the Madoff case, the SIPC Board prudently increased the assessments on SIPC member firms to .0025 percent of net operating revenues. At the close of 2014 SIPC had \$2.152 billion. Even including all expenses of the financial crisis, this demonstrates that SIPC has the ability to raise funds as needed to protect customers and meet its statutory obligations. The SIPC Board has currently set a "target" balance for the SIPC Fund at \$2.5 billion, which matches the increased line of credit SIPC has with the United States Treasury.

New Cases

Since December 2012, SIPC has initiated four customer protection proceedings, each of which is very modest in size. SIPC was able to serve as trustee in three of the cases, and use the statutory "direct payment procedure" in the fourth case. This has had the effect of expediting claims determination and satisfaction, in order to return customer assets as promptly as possible. Indeed two of those cases have already been brought to a conclusion. To put these cases in perspective with the cases discussed above, the combined cost to SIPC of protecting customers and administrative expenses in these four proceedings is approximately \$7 million.

Are there specific SIPC reforms that SIPC and Congress should consider and why?

Action on SIPC Nominees:

The Committee can assure that SIPC is in a position to be a rapid response team by moving the nomination of SIPC's directors.

I noted above that SIPC was able to initiate a customer protection proceeding for MF Global in a matter of hours. SIPC, by Bylaw, has delegated the authority to initiate a customer protection proceeding to the Chair. For more than a year, SIPC has been without a Chair, or a Vice Chair to serve as Acting Chair. That means that today SIPC might not be as nimble as it was on October 31, 2011, when I contacted SIPC's then Chairman for authority to protect investors in the MF Global case. With no Chair or Vice Chair, should that same urgent situation arise today I would have to call a meeting of the entire Board, on literally no notice.

Thus, I urge the Committee to move the nomination of SIPC's vacant director positions forward.

The SIPC Task Force, Rulemaking, and Legislation

In February 2010, SIPC's Board created a SIPC Modernization Task Force to formulate possible improvements to SIPA. In February 2012, the Task Force made a number of recommendations, five of which would require legislative change, and one of which required a rule change. (Nine recommendations, which could be implemented as a matter of policy, have been adopted.)

The SEC, working with SIPC, did institute a rule change requiring the independent auditors of SIPC member brokerage firms to file copies of their Audit Reports with SIPC. This program is part of an "early warning system" that gives SIPC the opportunity for informed discussion with regulators and self-regulators, who are responsible for notifying SIPC concerning brokerage firms that may pose a risk to investors.

After extended discussion the Board determined not to propose legislation that would increase the maximum level of protection, and eliminate the distinction in the

levels of protection for cash and securities. Among the reasons for the Board's decision was that such legislation would create disparate levels of protection offered by the FDIC and SIPC which could cause disruption and confusion, and also create inappropriate incentives to move funds from banks to brokerage firms. The Board also determined not to expand protection to participants in pension funds on a pass through basis.

The Task Force also suggested legislation setting a minimum assessment on SIPC members of the greater of \$1,000 or 0.02 percent of members' gross revenues from the securities business. Further, the Task Force suggested legislation authorizing the use of the "Direct Payment Procedure" where customer claims aggregate less than \$5 million. The Board discussed these proposals but deferred formally recommending a separate bill on these more minor matters until an appropriate opportunity arises.

Restoring Main Street Investor Protection and Confidence Act

While the letter inviting me to this hearing did not ask me to address the Restoring Main Street Investor Protection and Confidence Act, S. 67, that proposed legislation is relevant in the overall context of this hearing. Accordingly, Attachments A and B provide an analysis of that proposal.

I hope this summary has been helpful to the Subcommittee. I would be pleased to answer any questions the Subcommittee may have.

Attachment A

Concerns Respecting The Proposed Restoring Main Street Investor Protection and Confidence Act (S. 67)

The "Restoring Main Street Investor Protection and Confidence Act" contains provisions that have a number of what appear to be unintended consequences. Some of the concerns presented by the proposal include:

- The bill requires SIPC to accept as accurate financial statements known to be intentionally fraudulent. Under the bill, SIPC must accept whatever statement a thief issues to his customers.
- The bill legitimizes Ponzi Schemes by guaranteeing that the Scheme's non-existent trades at backdated stock prices giving rise to phony profits are backed by Federal taxpayer funds.
- The bill makes Ponzi Schemes a better investment than legitimate securities market trades by, among other things, eliminating market risk.
- The bill's limitations on the Bankruptcy Code's "avoidance powers" in a SIPA case result in demonstrably inequitable distributions of "customer property." For example, had Mr. Madoff's fraud been detected and closed a mere 2 days later, the \$175,000,000 in checks on his desk would have gone to arbitrarily favored clients at the direct expense of other clients to whom the funds actually belonged. This was more than half of the liquid assets the firm had when it failed. Further, as the United States Court of Appeals for the Second Circuit correctly noted, "any dollar paid to reimburse a fictitious profit is a dollar no longer available to pay claims for money actually invested."
- The bill provides a complex mechanism for honoring a fraudulent final account statement in the interest of equity. In reality, this is an invitation to extended litigation by various claimants with disparate, conflicting and competing interests in a *finite corpus* of customer property. This will delay the timely return of customer property to injured victims.
- The bill gives unprecedented and unlimited power to the SEC to compel the expenditure of both private and public funds. That power includes the authority to require SIPC to initiate the liquidation of any brokerage firm or other institution regardless of whether statutory criteria are met.
- The bill gives the SEC unlimited authority to change the definition of the term "customer."
- The bill renders the SEC's authority unreviewable by the judiciary.
- The bill operates retroactively. It would throw the Madoff case, and the remarkable results achieved to date, into chaos and uncertainty.
- The bill forbids using a trustee on two SIPA cases simultaneously. This eliminates efficiencies and denies customers the benefits of expertise in the most significant cases. SIPC has six ongoing proceedings. Only one individual serves in more than one case. SIPC matches the size and resources of the trustee and the trustee's counsel with the nature and scope of the problem.

- The bill makes it impossible to determine future costs and risk.

The bill would reverse the judicial outcome in the Stanford-Antigua Bank Fraud Case.

SIPC declined to initiate a customer protection proceeding for the Stanford Financial Group in connection with the Stanford-Antigua Bank Fraud. For the first time in SIPC's history, the SEC sued SIPC to compel SIPC to begin a proceeding. The District Court and Court of Appeals examined the circumstances and considered the legal issues in the case and determined that the victims of the Stanford Antigua Bank Fraud were not "customers" that SIPA was designed to protect.

The Restoring Main Street Investor Protection and Confidence Act, S. 67, would require SIPC to underwrite, guarantee, and pay the debt obligations, represented by Certificates of Deposit of the Stanford International Bank, a foreign bank in an offshore tax haven. The Antiguan Bank CD purchasers knowingly sent their money *away* from a SIPC member to an Antiguan Bank where, in the words of the SEC, the claimants received "high rates of return on CDs that greatly exceeded those offered by commercial banks in the United States."

While SIPC has sympathy for the victims of the Stanford and any other fraud, SIPC was not designed to refund the original purchase price of a bad investment, even where the investment was induced by fraud.



EQUITABLE TREATMENT OF INVESTORS

S. 67

An Analysis of the “Restoring Main Street Investor Protection and Confidence Act”

Stephen P. Harbeck
President and CEO

The Securities Investor Protection Corporation
September 30, 2015

This presentation demonstrates that the “avoidance powers” used by a SIPA trustee are essential to a fair and equitable distribution of assets in a Ponzi Scheme such as the Madoff case.



A One Sentence Summary of “Customer” Protection

SIPC protects the custody function that brokerage firms
perform for customers



Summary of Customer Protection

1. All “customer name securities” without limitation as to value.
2. A ratable share of the fund of “customer property”.
3. Advances from SIPC of up to \$500,000 for each customer, with a maximum of \$250,000 for a cash balance. To the maximum extent practicable, and assuming a fair and orderly market, the trustee will use SIPC advances to purchase securities to replace securities which may be missing.



Summary of Customer Protection

4. To the extent the customer's "net equity" is still unsatisfied, he participates as an unsecured creditor in the general estate of the debtor.

Note: SIPC advances may be, and as a practical matter usually are, made prior to a determination of each customer's ratable share of customer property.

- ▶ Assume three individuals deposit the same amount, on the same day.
- ▶ No Actual investments are made for the three customers.
- ▶ All three are credited with completely fictitious investment returns.
- ▶ Just prior to a discovery of the fraud, one customer makes a substantial withdrawal of his original investment, and some of the fictional profits.
- ▶ The other two customers make no withdrawal.
- ▶ The fraud is exposed.

- Under current law: No customer receives more than his original investment.
- Under the proposed legislation:

One customer receives:

- All of his principal investment
- Fictitious profits, in the form of money taken from the other two customers.

The other two customers receive:

- Far less than their original investment.

The Facts

DATE	Customer A	Customer B	Customer C
01/01/10	Deposits \$2 Million	Deposits \$2 Million	Deposits \$2 Million
01/01/11	Receives Statement \$4 Million	Receives Statement \$4 Million	Receives Statement \$4 Million
02/01/12	Withdraws \$3 Million	Withdraws Nothing	Withdraws Nothing
03/01/12	Receives Statement \$1 Million	Receives Statement \$4 Million	Receives Statement \$4 Million
06/01/12	Ponzi Scheme Exposed Broker's Assets and Other Customer Property Completely Dissipated on Filing Date		

WHAT DOES EACH CUSTOMER RECEIVE?

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Hypothetical 1: Assume total of \$6 million deposited and nothing available to distribute.

Results Under Current Law

	Customer A	Customer B	Customer C
Customer's Net Equity After \$1 Million Withdrawal by "A" Is Avoided	\$0 (Prior to liquidation, "A" already has received back his \$2 million principal. Only \$1 million representing fictitious profit is avoided)	\$2,000,000	\$2,000,000
Customer Property Distributed After Avoidance of \$1 Million Transfer to "A"	\$0	\$500,000	\$500,000
Amount Received From SIPC Advances	\$0	\$500,000	\$500,000
Total Amount Received Based on \$2 Million Deposit	\$0	\$1,000,000	\$1,000,000



Hypothetical 1: Assume total of \$6 million deposited and nothing available to distribute.

Results Under the Restoring Main Street Investor Protection and Confidence Act,”

	Customer A	Customer B	Customer C
Amount Withdrawn Pre Liquidation	\$3,000,000	-0-	-0-
Amount Received From SIPC Advance	\$500,000	\$500,000	\$500,000
Total Amount Received Based on \$2 Million Deposit	\$3,500,000	\$500,000	\$500,000

- Which is More Equitable?
- The Avoidance Powers That the Bill Takes Away Are Exactly What Makes the Distribution More Equitable.



Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of \$1,000,000

Results Under Current Law

	Customer A	Customer B	Customer C
Customer's Net Equity After "A's" \$1 Million Withdrawal is Avoided	\$0	\$2,000,000	\$2,000,000
Customer Property Distributed After Avoidance of Transfer To "A"	\$0	\$500,000	\$500,000
From SIPC	\$0	\$500,000	\$500,000
From Wrongdoer	\$0	\$500,000	\$500,000
TOTAL AMOUNT RECEIVED BASED ON \$2 MILLION DEPOSIT	\$2,000,000	\$1,500,000	\$1,500,000



Hypothetical 2: Assume Subsequent Recovery From Wrongdoer of \$1,000,000

Results Under the “Restoring Main Street Investor Protection and Confidence Act.”

	Customer A	Customer B	Customer C
Customer's Net Equity Based on Last Statement	\$1,000,000	\$4,000,000	\$4,000,000
Amount Withdrawn Pre-Liquidation	\$3,000,000	-0-	-0-
From SIPC	\$500,000	\$500,000	\$500,000
From Wrongdoer	\$111,111	\$444,444	\$444,444
TOTAL AMOUNT RECEIVED BASED ON \$2 MILLION DEPOSIT	\$3,611,111	\$944,444	\$944,444

CONCLUSIONS

- The avoidance powers make a more equitable distribution possible.
- Removing the avoidance powers gives fictional profits to some while depriving others of principal.

Memorandum

DATE September 28, 2015
TO United States Senate Subcommittee on Securities, Insurance and Investments
FROM Sigmund S. Wissner-Gross, Esq.

**REMARKS OF SIGMUND S. WISSNER-GROSS, ESQ.
OF BROWN RUDNICK, LLP**

I thank the Subcommittee for the opportunity to address the Subcommittee on the critically important subject of oversight of the Securities Investor Protection Corporation ("SIPC"). My statement set forth below addresses the three questions posed in Senator Crapo's September 17, 2015 letter.

I am a senior litigation partner in New York City at the international law firm of Brown Rudnick, LLP, where I serve as Co-Chair of the firm's Commercial Litigation department. Over the course of my thirty-three year legal career, I have specialized in litigating complex securities and related business litigation. I appear before the Subcommittee in my individual capacity, and not on behalf of my law firm. As a result, the views expressed herein are my own views, and are not presented as the formal position or views of Brown Rudnick.

During the period from 2000-2006, I acted as lead counsel on behalf of numerous defrauded investors in litigating against the SIPC-appointed Trustee over a range of customer coverage disputes in the SIPA matter of New Times Securities Services, Inc. ("New Times"). New Times involved a classic ponzi scheme run by William Goren, the owner of New Times, a Long Island based broker-dealer. For several hundred customers, many elderly and retirees of very modest means, Goren

embezzled their life savings, instead of purchasing as promised mutual fund shares or shares of a purported (but non-existent) money-market fund named “New Age Securities Money Market Fund.”¹

Although the New Times matter was pre-Madoff and involved embezzled customer funds on an order of magnitude far less than the Madoff ponzi scheme and other mega-ponzi schemes that have imploded in recent years, the lessons of the New Times matter, and the fight I had to pursue to attempt to secure a recovery for six years on behalf of defrauded Goren investors, are instructive to the questions this Subcommittee has raised. Moreover, although SIPC’s involvement in the Bernard L. Madoff Investment Securities and Lehman Brothers Inc. proceedings (and MF Global Inc. beginning in 2011) have dominated the press in recent years, the reality is that prior to and after those notable filings many of the approximately 328 SIPA proceedings that have occurred since passage of the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa, *et seq.* (“SIPA”) have not been mega-bankruptcies, and have involved embezzlement schemes on an order of magnitude such as was evident in New Times. I also recognize that there are years when there are no SIPC-initiated new customer proceedings. On the other hand, it has become increasingly evident, as reflected in SIPC’s unwillingness to initiate SIPA proceedings in cases such as the Stanford Group Company (a SIPC member), where SIPC’s decision to challenge the Securities and Exchange Commission’s (“SEC”) request that SIPC initiate a SIPA proceeding was sustained by both the District Court and the District of Columbia Court of Appeals, *SEC v. SIPC*, 758 F.3d 357 (D.C. Cir. 2014), that a careful review needs to be made as to whether SIPA needs to be more equitable and fairly reflect the reality of how investors need to be protected against broker-dealer failure that

¹ Goren dominated and controlled both New Times and his related New Age entities, with assets commingled and used both New Times and New Age to perpetrate his fraud.

occurs as a result of fraud and/or abuse. Indeed, as SIPC acknowledges every year in its Annual Report, SIPA's "purpose is to afford certain protections against loss to customers resulting from broker-dealer failure and, thereby, promote investor confidence in the nation's securities markets." To the extent that SIPA has not provided adequate protection to customers, it needs to be amended; to the extent SIPC has not sufficiently acted to promote "investor confidence" in the nation's securities markets, it needs to be overhauled, or as has been suggested in some recent legislative proposals, the SEC needs to be given a greater role in determining when intervention by SIPC is warranted or in the selection of the critical role of a Trustee when a SIPC-initiated proceeding occurs.

While my primary experience with SIPC was confined to a six-year period, during which we ultimately prevailed in forcing the SIPC-appointed Trustee to first, consent to bankruptcy consolidation that resulted in the SIPC-appointed Trustee conceding that the defrauded investors were "customers" for purposes of SIPA and thereafter we were able to obtain a recovery for most of such investors,² I believe that the New Times matter is illustrative of the fight that defrauded investors have had to battle in other SIPA proceedings.

² We did not prevail, unfortunately, in securing SIPA recovery for a widow and a single mother who was battling cancer in recovering her investment losses after Goren defrauded her to invest in his bogus money market fund, then "took" such non-existent investment and "rolled it" over into a promissory note investment. See *In re New Times Securities Services, Inc., et al. v. James Giddens, et al.*, 463 F.3d 125 (2d Cir. 2006). One of the claimants, Mary Ann Stafford, had invested \$75,000 with Goren to purchase money market funds. Goren embezzled her monies. After embezzling such funds, Goren convinced Ms. Stafford to "sell" such money market shares (which, in fact, did not exist) and "reinvest the proceeds in interest-bearing promissory notes, with Goren and the Debtor as the obligors." Though Ms. Stafford clearly was defrauded, and her initial investment in the non-existent money market fund was clearly an SIPA-covered investment, her decision to "sell" the non-existent money market investment and invest in a non-existing transaction with Goren, according to the SIPC-appointed Trustee (James Giddens), disqualified Ms. Stafford from "customer" status and therefore from SIPA-protection. Ms. Stafford, a single mother who was battling cancer, and desperately needed such funds to survive, was a victim of both Goren's fraud and SIPC's refusal to embrace her customer status. While the Second Circuit reversed a District Court ruling in favor of Ms. Stafford and ultimately endorsed SIPC's position, it was, in my view, unconscionable for the SIPC-appointed Trustee and SIPC to have taken such a harsh, unfair and inequitable approach to Ms. Stafford's claim.

In New Times, the investors were individuals of modest means, including many retirees who had invested their life savings with Goren—my clients included a retired plumber who was a Holocaust survivor and lost his entire life savings of several hundred thousand dollars investing in Goren’s non-existent money-market fund; a couple from Brooklyn who sold their home (their largest single asset) and invested the proceeds of the sale (several hundred thousand dollars) into Goren’s fictitious money-market fund as a purportedly safe harbor while trying to figure out where to further invest the proceeds; a Long Island businessman, who invested over \$500,000 (his life savings) into Goren’s money-market fund, etc. It was not in dispute that Goren preyed on the most innocent of victims, and that instead of purchasing any securities, Goren embezzled investor funds, and sent phony confirmations of trades that were never executed, and phony account statements, until his fraud was exposed. For his part, Goren pled guilty to his criminal conduct and was sentenced to 87 months in federal prison.

The procedural history of the New Times matter, and of certain of the issues I litigated to the United States Court of Appeals for the Second Circuit, are set forth in the Second Circuit’s ruling, a copy of which is attached to this witness statement. See *In re New Times Securities Services, Inc.*, 371 F.3d 68 (2d Cir. 2004) (“**New Times I**”), annexed as Exhibit A hereto.³

My conclusions at the time, based on my dealings with SIPC, the SIPC-appointed Trustee, and the SEC in connection with the New Times matter were as follows:

³ A copy of a subsequent New Times ruling, involving claims of defrauded investors discussed in footnote 2 above, is annexed as Exhibit B hereto. See *In re New Times Securities Services, Inc., et al. v. James Giddens, et al.*, 463 F.3d 125 (2d Cir. 2006) (“**New Times II**”).

- Even after “customer” status was recognized, the SIPC-appointed Trustee vigorously fought individual customers on establishing their losses, which required my negotiating with counsel to the SIPC-appointed Trustee on a one-off basis for numerous customers affected.⁴ I found, at times, that SIPC was making concerted efforts to avoid payments being made to the defrauded customers. The defrauded customers were both bewildered and frustrated that, at every step of the way, we had to battle the Trustee to secure recoveries for them.
- In the case of the issue of whether investors who invested more than \$100,000 in Mr. Goren’s fictitious money-market account (and lost in most cases, their entire life savings) were entitled to a claim for cash (*i.e.*, subject to an existing \$100,000 cap⁵) or a claim for securities (*i.e.*, subject to a \$500,000 cap), I was forced to litigate that issue against the Trustee through three courts over several years—the Bankruptcy Court, the District Court for the Eastern District of New York and the Second Circuit, before the Trustee (after losing three times) finally relented and agreed to pay such defrauded investors their out-of-pocket losses up to \$500,000 per investor, as directed by the Second Circuit. The Bankruptcy Judge originally assigned the case expressed such frustration at the conduct of SIPC in trying to thwart the innocent victims of Goren’s criminal conduct that he recused himself from the case, indignant over the recalcitrance of SIPC and the SIPC-appointed Trustee in recognizing the right of Goren’s innocent victims who were deceived into investing in New Age (*i.e.*, not have their undisputed out-of-pocket losses capped as

⁴ While technically SIPC “recommends” appointment of a trustee to the Court, in practical reality, the trustee is “appointed” by SIPC.

⁵ In 2010, the cap for claims for cash was increased from \$100,000 to \$250,000. See 15 U.S.C. § 78fff-3.

“claims for cash”). After the Bankruptcy Judge recused himself, the District Judge withdrew the bankruptcy reference for the case and decided the issue favorably for the investors. For its part, the SEC did not get involved in formally expressing a position on the issues, until at the direction of the Second Circuit, the SEC was instructed to submit a formal written position on the issues on appeal to the Second Circuit. I then was asked by the SEC to come to Washington, D.C. and meet with the SEC and its general counsel to explain our position on the appeal. We were ultimately successful in persuading the SEC to endorse our central argument, namely that defrauded investors who invested in what they understood to be a legitimate (but it turned out non-existent) money-market fund were entitled to be treated as having claims for securities and to receive up to \$500,000 for their respective losses. The SEC, in turn, in its submission to the Second Circuit, embraced our core contention that the defrauded investors who believed they had purchased shares in what proved to be a non-existent money-market fund, were entitled to have their claims treated as claims for securities, and receive their net cash out-of-pocket loss up to \$500,000 each, respectively.

- I found the role of the SEC to be somewhat dysfunctional. While the SEC had oversight responsibility in the matter and was entitled to intervene in the matter, they were detached from the day-to-day issues, and on the appeal, it was only when the SEC was directed by the Second Circuit to state a formal position that it finally entertained and ultimately supported our arguments on behalf of the defrauded investors. As the Second Circuit in **New Times I** noted, “it appears that the SEC generally adopts a hands-off approach with respect to SIPC liquidations (and

litigation).” It was clear to me that far greater SEC oversight is needed for SIPC’s handling of such cases.

- While counsel selected by SIPC to act as Trustee in my case is an excellent law firm, I found that, in reality, they acted on all key decisions at the direction of SIPC, and forced the defrauded investors, many of whom elderly and virtually all of very limited resources, to fight until the Court pressured the SIPC-appointed Trustee and SIPC to relent and acknowledge customer status and cover customer claims. While the Trustee is supposed to be acting independently of SIPC, in my experience, the Trustee in fact looked to SIPC for guidance and direction on virtually every position the Trustee took. I would encourage legislative consideration of ways to ensure greater independence of trustees who are appointed, with a mandate to trustees to focus on maximizing investor recoveries. One sensible suggestion would be to transfer from SIPC to SEC authority to nominate to a Court persons for appointment as trustee for the liquidation of a debtor’s business and as attorney for the trustee, and to ensure the independence of such trustee during the process of such trustee acting in such role.
- There also is clearly a need, based on my experience, for other reforms of SIPA – as noted, the SEC needs to be much more actively involved in oversight of SIPC; the ability of the SEC (as well as SIPC) to apply for a protective decree on a SIPC member’s behalf, as proposed in the proposed “Restoring Main Street Investor Protection Act,” would help to avoid the unfortunate and unsuccessful result as occurred in the effort of the SEC to seek a court order (opposed by SIPC) compelling SIPC to liquidate a member broker-dealer, Stanford Group Company. *See SEC v.*

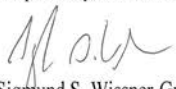
Securities Investor Protection Corp., 758 F.3d 357 (D.C. Cir. 2014); the definition of “customer” for purposes of the SIPA statute needs to be expanded to embrace a wider net of defrauded investors who should be protected by SIPA’s safety net; as in the case of Ms. Stafford noted above in **New Times II** (a single mother, battling cancer, who was denied SIPA coverage even though her “nest egg” of \$75,000 was embezzled by Goren after she thought she had purchased money-market fund shares), SIPC and any SIPC-appointed trustee should be required by statute to presume SIPA coverage in the many gray areas that exist where, due to the nature of how broker-dealer fraud is perpetrated, a particular investor’s situation falls in a gray area where the SIPA statute and applicable regulations do not provide clear guidance. SIPC, in my experience, has focused more on its efforts to limit tapping of the reserve fund available to SIPC than in making every effort to ensure that defrauded customers are covered to the maximum amount possible. The proposed expanded definition of customer in the “Restoring Main Street Investor Protection and Confidence Act” would further the needed protection. Inasmuch as innocent investors, and in particular the elderly and retirees, are extremely vulnerable to investment fraud perpetrated on them to entice them to invest significant funds (often life savings) into investment schemes or programs that prove to be bogus, or are otherwise at risk of embezzlement of their investments, SIPA needs to be flexible enough to ensure that the reasonable expectations of investors are properly protected. A more elastic definition of “customer” or customer covered “claims” to equitably and fairly protect defrauded investors is warranted. I would endorse many of the proposed reforms set forth in the

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September 28, 2015
Page 9

proposed "Restoring Main Street Investor Protection and Confidence Act," S. 67.

I thank the Subcommittee for its time and consideration of the foregoing remarks.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "S. S. Wissner-Gross", written in a cursive style.

Sigmund S. Wissner-Gross

EXHIBIT A

In re New Times Securities Services, Inc., 371 F.3d 68 (2004)
 Fed. Sec. L. Rep. P 92,838, 43 Bankr.Ct.Dec. 45

371 F.3d 68
 United States Court of Appeals,
 Second Circuit.

In re: NEW TIMES SECURITIES SERVICES, INC.
 and New Age Financial Services, Inc., Debtors.
 Myrna K. Jacobs, Simon and Helga Noveck,
 Miriam Seidenberg, Felice Linder, Angelo Scarlata,
 the Rose Marie Ceparano Irrevocable Trust,
 the Estate of Allan A. Blynd, Salvatore and
 Stella DiGiorgio, Project Earth Environmental
 Fundraisers, Inc., New York Optical, Inc., the Carl
 Carter Irrevocable Trust, Craig Roffman, Ellen
 Eschen, and Jill Gundry, Claimants–Appellees.

Docket No. 02–6166. | Argued: June 26,
 2003. | Last Supplemental Briefs Filed:
 July 22, 2003. | Decided: June 8, 2004.

Synopsis

Background: Purchasers of bogus securities filed objections to Securities Investor Protection Corporation's (SIPC) classification of their claims in liquidation proceeding under Securities Investor Protection Act. The United States District Court for the Eastern District of New York, Thomas C. Platt, J., 206 F.Supp.2d 344, sustained purchasers' objections, and appeal was taken.

Holdings: The Court of Appeals, Straub, Circuit Judge, addressing issues of first impression, held that:

- [1] SIPC's interpretation of SIPA was not entitled to deference;
- [2] Securities and Exchange Commission's (SEC) interpretation of SIPA was entitled to limited *Skidmore* deference;
- [3] purchasers had "claims for securities" rather than "claims for cash" under SIPA; and
- [4] purchasers' claims were required to be valued according to the amount they initially paid for the securities.

Affirmed in part; vacated and remanded in part.

Attorneys and Law Firms

***70** James B. Kobak, Jr., Hughes Hubbard & Reed, LLP, New York, NY, for Appellant James W. Giddens as Trustee for the Liquidation of New Times Securities Services, Inc., and New Age Financial Services, Inc.

Karen A. Caplan, Securities Investor Protection Corporation (Stephen P. Harbeck, General Counsel, on the brief), Washington, DC, for Appellant Securities Investor Protection Corporation.

Sigmund S. Wissner-Gross, Heller Horowitz & Feit, P.C., New York, N.Y. (May Orenstein, Heller Horowitz & Feit, P.C., New York, NY, Ted A. Berkowitz, Farrel Fritz, P.C., Uniondale, NY, on the brief), for all Claimants–Appellees other than Jill Gundry.

Giovanni P. Prezioso, General Counsel, Securities and Exchange Commission (Jacob H. Stillman, Solicitor, Hope Hall Augustini, Senior Litigation Counsel, on the brief), Washington, DC, for amicus curiae Securities and Exchange Commission.

***71** Before: STRAUB and POOLER, Circuit Judges, and HURD, District Judge. *

Opinion

STRAUB, Circuit Judge.

The Claimants–Appellees (the "Claimants") whose reimbursement is the subject of this appeal are individuals and entities that were fraudulently induced by William Goren to purchase shares in bogus mutual funds offered by his investment companies, New Times Securities Services, Inc. ("New Times") and New Age Financial Services, Inc. ("New Age") (collectively, the "Debtors"). After Goren's long-running scheme was exposed, the United States District Court for the Eastern District of New York (Thomas C. Platt, *Judge*) ordered that the assets of New Times and New Age be liquidated pursuant to the Securities Investor Protection Act of 1970 ("SIPA"), 15 U.S.C. §§ 78aaa–78lll (2003).

In the course of that liquidation, the SIPA Trustee concluded that the Claimants were eligible to receive cash advances from the Securities Investor Protection Corporation ("SIPC"), but that they had "claims for cash" subject to a \$100,000 reimbursement limit under SIPA. He set the value of the

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claims at the amount of money that the Claimants paid to the Debtors to purchase the bogus funds. The Claimants filed objections to the Trustee's determinations and the District Court sustained the objections, holding that (i) the Claimants, in fact, had "claims for securities" eligible for much more generous SIPC advances of up to \$500,000, and (ii) the claims were properly valued according to the equity positions reflected in the Claimants' final account statements from the Debtors, which included interest and fictitious dividend reinvestments. The Trustee and SIPC appeal from that ruling.

This appeal requires resolution of issues of first impression in the Second Circuit. We hold today that the District Court properly determined that the Claimants had "claims for securities" under SIPA but we find that the District Court erred by calculating the value of those claims by reference to the fictitious account statements that the Claimants received from the Debtors. Instead, each Claimant's net equity should be calculated by reference to the amount of money the Claimants originally invested with the Debtors (not including any fictitious interest or dividend reinvestments). In so holding, we decline to adopt SIPC's narrow reading of the relevant SIPA provisions and, instead, defer to the SEC's persuasive interpretation of the statute.

BACKGROUND

A. Goren's Fraud

From approximately 1983 until 2000, through New Times and New Age, Goren defrauded hundreds of Long Island and Queens, New York investors out of approximately \$32.7 million.¹ Goren's scheme was multifaceted. He solicited customers of New Age and New Times to invest in (i) one or more non-existent money market funds (often called the New Age Securities Money Market Fund), (ii) shares of bona fide mutual funds (from, e.g., The Vanguard Group and Putnam Investments), that were never, in fact, purchased, and (iii) fraudulent promissory notes issued by Goren and/or New Age. Instead of investing these customers' *72 funds as represented, Goren misappropriated the money.²

On February 17, 2000, the SEC filed a complaint in the United States District Court for the Eastern District of New York against Goren and New Age (and naming New Times as a relief defendant), alleging violations of the Securities Acts and seeking preliminary and permanent injunctive relief. The following day, the District Court (Thomas C. Platt, *Judge*) issued a preliminary injunction freezing Goren's assets and

appointed a temporary receiver for New Age and New Times. Goren eventually pleaded guilty to securities fraud charges arising from his role in orchestrating and operating this far-reaching scheme. He is currently serving an 87-month prison sentence.

B. The SIPA Liquidation

On May 18, 2000, the District Court ordered that New Times, a registered member of SIPC,³ be liquidated pursuant to SIPA. Upon the recommendation of SIPC, the court appointed James W. Giddens to serve as the Trustee for the New Times liquidation. The proceeding was referred to the United States Bankruptcy Court for the Eastern District of New York (Stan Bernstein, *Bankruptcy Judge*). (New Age remained in receivership under the jurisdiction of the District Court.)

During a standard SIPA liquidation, the trustee must "satisfy net equity claims of customers" of the failed broker-dealer. 15 U.S.C. § 78fff(a)(1)(A)-(B). Each customer's "net equity" is "the dollar amount of the account or accounts of a customer, to be determined by calculating the sum which would have been owed by the debtor to such customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of such customer" corrected for "any indebtedness of such customer to the debtor on the filing date."⁴ *Id.* § 78lll (11). These net equity claims are paid first by a pro rata distribution *73 of "customer property," which is defined as "cash and securities" held by the debtor (excluding any non-negotiable securities held in a particular customer's name). *Id.* § 78lll (4).

SIPC maintains a substantial reserve fund that is supported by assessments on SIPC members' revenues and by interest generated from its investments in U.S. Treasury notes.⁵ See *id.* § 78ddd(a), (c); see also *Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 222 F.3d 63, 66 (2d Cir.2000); U.S. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-03-811, SEC. INVESTOR PROT.: UPDATE ON MATTERS RELATED TO THE SIPC 8 (2003), available at <http://www.gao.gov> ("2003 GAO REPORT"). To the extent that a customer's net equity exceeds his ratable share of customer property, the trustee may use SIPC advances from this fund to pay customers in cash or to purchase replacement securities for a customer.⁶ 15 U.S.C. §§ 78fff-2(d), 78fff-3(a).

These SIPC advances are subject to one of two limits under SIPA, which is why the determination of whether a customer

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has a "claim for cash" or a "claim for securities" must be made. SIPA provides that the "SIPC shall advance to the trustee such moneys, not to exceed \$500,000 for each customer, as may be required to pay or otherwise satisfy claims for the amount by which the net equity of each customer exceeds his ratable share of customer property." *Id.* § 78fff-3(a). If, however, any portion of that claim is a "claim for cash, as distinct from a claim for securities, the amount advanced to satisfy such claim for cash shall not exceed \$100,000 for each such customer." *Id.* § 78fff-3(a)(1).

Early in the New Times liquidation, the Trustee's review of the operations of New Times and New Age "revealed extensive intermingling of the two entities in communications with the public." Br. for Appellants James W. Giddens and SIPC at 5. As a result, with the approval of SIPC, the Trustee "moved for an order substantively consolidating the estates of New Times and New Age ... so as to maximize recovery to victims of Goren's fraudulent activities, irrespective of whether they had dealt with New Times, the broker-dealer entity or New Age, the non broker-dealer entity." *Id.* The SEC filed a brief in support of such a consolidation, and on November 27, 2000, the Bankruptcy Court granted the Trustee's motion. As a result, the assets and liabilities of the two entities were pooled and the combined estate has since been administered by the Trustee under the jurisdiction of the Bankruptcy Court. Customer claims have been determined according to SIPA and the debtor, for SIPA purposes, includes both New Times and New Age for claims arising after April 19, 1995, which is the date that New Times became an SEC-registered broker-dealer and a member of SIPC.

C. The Trustee's Determination: "Claims for Cash" vs. "Claims for Securities"

Over 900 claims have been filed in the liquidation proceeding. The fourteen Claimants whose reimbursement is the *74 subject of this appeal are among 174 claimants who, fraudulently induced by Goren, "invested" in his bogus money market funds ("the Funds" or "the New Age Funds").⁷ It is worth noting that there is no suggestion that any of the Claimants, many of whom were elderly retirees, had any suspicion of Goren's criminality or of the non-existence of the New Age Funds in which he claimed to have invested their money. To the contrary, all of the Claimants have indicated that they believed they were investing in low-risk, conservative money market mutual funds.

To be clear—and this is the crucial fact in this case—the New Age Funds in which the Claimants invested *never* existed. They were not organized as mutual funds, they were never registered with the SEC and they did not issue any of the requisite prospectuses for investors. Although the Claimants received confirmations and monthly account statements indicating that their initial payments to the Debtors (and fictitious dividends) were invested in the New Age Funds, in reality, Goren had embezzled their money.

Because the claims were for non-existent securities, the Trustee concluded during the liquidation proceedings that the Claimants had "claims for cash" (eligible for only \$100,000 in cash advances) and he valued those claims according to the amount paid to the Debtors for the purchase of the bogus shares, less any withdrawals or redemptions by the Claimants. Amounts shown on the Claimants' account statements as dividends or interest earned on the bogus funds were not included in the calculus. *SEC v. Goren*, 206 F.Supp.2d 344, 347 (E.D.N.Y.2002). The Trustee made it clear to the Claimants that any amounts they were owed in excess of \$100,000 would be treated by the Debtors' estate as general unsecured claims, but the Trustee "warned the Claimants that the consolidated New Age and New Times estate would likely lack funds to satisfy any general unsecured claims." *Id.*

Meanwhile, investors who were misled by Goren to believe that they were investing in mutual funds that in reality existed were treated much more favorably. Although they were not actually invested in those real funds—because Goren never executed the transactions—the information that these claimants received on their account statements "mirrored what would have happened had the given transaction been executed." Br. for Appellants James W. Giddens and SIPC at 7 n. 6. As a result, the Trustee deemed those customers' claims to be "securities claims" eligible to receive up to \$500,000 in SIPC advances. *Id.* The Trustee indicates that this disparate treatment was justified because he could purchase real, existing securities to satisfy such securities claims. *Id.* Furthermore, the Trustee notes that, if they were checking on their mutual funds, the "securities claimants," in contrast to the "cash claimants" bringing this appeal, could have confirmed the existence of those funds and tracked the funds' performance against Goren's account statements. *Id.*

D. The District Court Decision

Thereafter, the Claimants filed written objections to both (i) the Trustee's determination of their claims as cash claims and (ii) his refusal to compensate them for interest and

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dividend reinvestments. See *Goren*, 206 F.Supp.2d at 347. In response, the Trustee (joined by SIPC) moved for an ***75** order upholding his determination. *Id.* While these objections and motions were pending, Bankruptcy Judge Bernstein recused himself from the case. *Id.* at 348. Thereafter, District Court Judge Platt withdrew the reference and took exclusive jurisdiction of the SIPC proceeding. *Id.*

After reviewing the matter, the District Court denied the Trustee's motion and sustained the Claimants' objections in a May 28, 2002 Memorandum and Order. The court determined that the Claimants had claims for securities and that the value of those claims could be derived from the Claimants' equity positions as stated in their final account statements (including the fictitious interest and dividend reinvestments). *Id.* at 351–52. The court explained that, in keeping with SIPA policy goals, this result “turns on the transaction notice provided to customers and their legitimate expectations” and “promotes investor confidence.” *Id.* at 351. The District Court relied on the “Series 500 Rules,” 17 C.F.R. §§ 300.500–503, in reaching this conclusion.⁸ *Goren*, 206 F.Supp.2d at 350 (explaining that, under the Series 500 Rules, “receipt of written confirmation of the purchase or sale of a security generally determines what type of claim customers hold”). In the District Court's view, the Trustee's determination erroneously “hinge[d] on the unilateral actions of the fraudfeasor who embezzled his clients' funds.” *Id.* at 351.

The Trustee and SIPC promptly filed a Joint Notice of Appeal. On June 20, 2003, responding to our request, the SEC filed an *amicus* brief in partial support of the Claimants and in partial support of the Trustee and SIPC.

DISCUSSION

This appeal presents several issues of first impression in this Circuit. First, we are called upon to determine whether the Claimants should be treated as having “claims for securities” under section 9(a)(1) of SIPA, 15 U.S.C. § 78fff–3(a)(1), which are eligible for SIPC cash advances of up to \$500,000, or as having “claims for cash,” which are eligible for reimbursement capped at \$100,000. Second, if the District Court properly held that the claims were “claims for securities,” we must evaluate whether the District Court properly calculated the Claimants' “net equity” by referring to the fictitious securities positions reflected in the Claimants' account statements (which included artificial interest and

dividend reinvestments). Finally, in the course of addressing these novel issues of statutory interpretation, we confront the still thornier question of whether and to what degree we ought to defer to the SEC's interpretation of the relevant provisions of SIPA when it *directly contradicts* SIPC's reading of the statute.

I. THE CONFLICTING INTERPRETATIONS OF SIPA

We review *de novo* the District Court's conclusions of law, including its interpretation of SIPA and the Series 500 Rules. See *Gurary v. Nu-Tech Bio-Med, Inc.*, 303 F.3d 212, 219 (2d Cir.2002), *cert. denied*, 538 U.S. 923, 123 S.Ct. 1583, 155 L.Ed.2d 314 (2003); *Levy v. Southbrook Int'l Inv., Ltd.*, 263 F.3d 10, 14 (2d Cir.2001), *cert. denied*, 535 U.S. 1054, 122 S.Ct. 1911, 152 L.Ed.2d 821 (2002).

***76** In this case, the SEC has outlined an interpretation of section 9(a)(1) of SIPA that plainly conflicts with the interpretation being pressed by SIPC and the Trustee.⁹ All three agree, however, that (i) the Claimants were “customers” pursuant to SIPA because they “deposited cash with the debtor for the purpose of purchasing securities,” 15 U.S.C. § 78fff (2); (ii) the securities in question did not exist and, thus, could not be liquidated or replaced by the Trustee; (iii) the Series 500 Rules do not govern this case; and (iv) the Trustee properly measured the Claimants' “net equity” by reference to the amount of money they paid to Goren and the Debtors to purchase the bogus funds.¹⁰

At this point, the interpretations diverge. The Trustee and SIPC work backward from the determination of the Claimants' “net equity,” which is the sum they would have been owed by the Debtors if the Debtors had liquidated, on the filing date, all of the Claimants' securities positions. See 15 U.S.C. § 78fff (11). Because here there were no securities to liquidate, the Trustee had to value the claims according to the amount of “cash” that the Claimants initially paid to the Debtors for their investments in the New Age Funds. For that reason, SIPC and the Trustee conclude the claims are properly viewed as cash claims under section 9(a)(1) and, thus, limited to \$100,000 in SIPC advances. See *id.* § 78fff–3(a)(1).

The SEC rejects this outcome-oriented test, instead focusing on Congress's intent in creating the distinction between the two types of claims and, derivatively, on satisfaction of the customer's legitimate expectations. According to the SEC, the Claimants should be treated as having “claims for

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securities”—regardless of the fact that the securities were fictitious—because they received purchase confirmations and account statements from Goren and the Debtors. Br. for *Amicus Curiae* SEC at 2, 8.

Before we consider whether and to what degree we ought to defer to either interpretation, we must examine the relationship between the SEC and SIPC.

II. THE RELATIONSHIP BETWEEN SIPC AND THE SEC

A. SIPA

[1] By the explicit language of SIPA, SIPC is *not* “an agency or establishment of the United States Government.” 15 U.S.C. § 78ccc(a)(1)(A). SIPC asserts that although it is not an agency “*per se*,” it is, under SIPA, “an independent corporation” endowed with “its own voice and responsibilities in the conduct of liquidations and payment of net equity claims from the SIPC Fund.” Letter from Harbeck, General Counsel, SIPC, to the Court of 7/3/03 (“Harbeck Letter”), at 1. According to SIPC, the SEC “possesses potential supervisory authority in some but not all areas of SIPC’s operations.” *Id.* (citing 15 U.S.C. § 78ggg(c)). Although we agree with SIPC that the drafters of SIPA clearly envisioned roles for both the SEC and SIPC in administering the statute,¹¹ see 3 *77 THOMAS LEE HAZEN, LAW SECURITIES REGULATION § 14.24 (2002), we find that Congress deliberately limited the authority of SIPC relative to the SEC.

The Supreme Court held in *Securities Investor Protection Corporation v. Barbour*, 421 U.S. 412, 95 S.Ct. 1733, 44 L.Ed.2d 263 (1975), that SIPA invests the SEC with “‘plenary authority’ to supervise the SIPC.” *Id.* at 417, 95 S.Ct. 1733. Indeed, SIPA drafters seem to have anticipated “substantial” and “vigorous” oversight of SIPC by the SEC. H.R. REP. NO. 91–1613, at 11–12 (1970), *reprinted in* 1970 U.S.C.A.N. 5254, 5265 (explaining that SIPA provides for “substantial oversight on the part of the Commission over the conduct of the affairs of SIPC”); *id.* at 5266 (noting that the House Committee on Interstate and Foreign Commerce “not only directs, but expects the Commission to use its oversight in a vigorous, but fair, manner”); *see also* *Sec. Investor Prot. Corp. v. Charisma Sec. Corp.*, 506 F.2d 1191, 1196 & n. 7 (2d Cir.1974) (“In fact, it is contemplated that the SEC will exercise a supervisory role over SIPC performance.”).

For example, although SIPA provides SIPC with the power to adopt, amend or repeal bylaws and rules as “necessary or appropriate” to further the purposes of SIPA, 15 U.S.C. § 78ccc(b)(3), (4), the SEC may disapprove any such bylaw in whole or in part, and any proposed rule or rule change must be filed with and approved by the SEC before it takes effect, *id.* § 78ccc(e)(1)(A), (2). Indeed, the Series 500 Rules, 17 C.F.R. §§ 300.500–503, which the District Court held govern this case,¹² *see Goren*, 206 F.Supp.2d at 350–51, were proposed by SIPC and approved by the SEC in just that manner, *see* 17 C.F.R. § 300.100 (explanatory note). SIPA also empowers the SEC to take an even more proactive rule-making role: “The [SEC] may, by such rules as it determines to be necessary or appropriate in the public interest or to carry out the purposes of this chapter, *require* SIPC to adopt, amend or repeal any SIPC bylaw or rule, whenever adopted.” 15 U.S.C. § 78ccc(e) (3) (emphasis added).

In addition, the SEC may, “on its own motion,” file an appearance in any SIPC-initiated proceeding and “may thereafter participate as a party.” *Id.* § 78ccc(c). Even more significantly, “[i]n the event of the refusal of SIPC to commit its funds or otherwise to act for the protection of customers of any member of SIPC,” SIPA authorizes the SEC to seek a court order “requiring SIPC to discharge its obligations under [SIPA] and for such other relief as the court may deem appropriate to carry out the purposes of [SIPA].” *Id.* § 78ggg(b); *see also* *Barbour*, 421 U.S. at 417–18, 95 S.Ct. 1733; 3 HAZEN, *supra*, § 14.24.

B. Deference to SIPC’s Interpretation Is Inappropriate in this Case

Shortly after SIPC was formed, this Court considered, in an entirely different *78 context, the degree of deference that should be accorded to SIPC’s interpretation of a different provision of SIPA. Noting its “familiarity with SIPA liquidations,” SIPC argued that it should be given deference on a par with that given to an SEC interpretation. *Sec. Investor Prot. Corp. v. Charisma Sec. Corp.*, 506 F.2d 1191, 1196 (2d Cir.1974). The *Charisma Securities* court noted that while SIPC’s expertise “should be accorded weight by a district judge,” the court was “hesita[nt] to draw the analogy between the Corporation and the SEC,” because the “SIPC is not an independent regulatory agency, ... nor has it yet had the opportunity to establish a long history of knowledgeable and conscientious performance as has the SEC.”¹³ *Id.*; *see also* *In re Lloyd Sec.*, 163 B.R. 242, 253 (Bankr.E.D.Pa.1994) (stating that because SIPC is “not a governmental agency, ...

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it cannot take advantage of the implicit deference which must be accorded to federal agencies' interpretations of their own pertinent statutory schemes and operative administrative regulations"), *aff'd in part, rev'd in part on other grounds*, 183 B.R. 386 (E.D.Pa.1995), *aff'd*, 75 F.3d 853 (3d Cir.1996).

Although SIPC now has the "history of knowledgeable and conscientious performance" under SIPA that it lacked when *Charisma Securities* was decided, its status vis-à-vis the SEC—and as a non-agency—has not changed. SIPC argues that other government-created corporations have been accorded *Chevron*-style deference, *see* Harbeck Letter at 6 (citing *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 110 S.Ct. 2668, 110 L.Ed.2d 579 (1990); *Velazquez v. Legal Servs. Corp.*, 164 F.3d 757 (2d Cir.1999), *aff'd*, 531 U.S. 533, 121 S.Ct. 1043, 149 L.Ed.2d 63 (2001)), but we find that the entities at issue in those cases are dissimilar to SIPC in critical respects. The Pension Benefit Guaranty Corporation ("PBGC") was established as an entity "within the Department of Labor," with the power "to adopt, amend, and repeal" necessary "bylaws, rules, and regulations." 29 U.S.C. § 1302(a), (b)(3). As such, we have characterized PBGC as a "federal agency." *Jones & Laughlin Hourly Pension Plan v. LTV Corp.*, 824 F.2d 197, 201 (2d Cir.1987); *see also LTV Corp.*, 496 U.S. at 647, 110 S.Ct. 2668 (repeatedly characterizing PBGC as an agency). SIPC, on the other hand, does not have similar authority.

With respect to the Legal Services Corporation ("LSC"), the other government-created corporation cited by SIPC, the SEC notes that although LSC is not a government agency, it is unlike SIPC because "its enabling statute gives it final authority to promulgate rules." Letter from Prezioso, General Counsel, SEC, to the Court of 7/21/03 ("Prezioso Letter"), at 8. We agree. *See Texas Rural Legal Aid, Inc. v. Legal Servs. Corp.*, 940 F.2d 685, 689–90 (D.C.Cir.1991) (according *Chevron* deference to LSC interpretation because, although LSC is not an agency, "Congress has entrusted LSC with the duty to administer the [Legal Services Corporation] Act and ... has delegated to LSC the authority to fill any gap left ... by Congress" through "notice-and-comment rulemaking ..., indicating that Congress intended that it be treated for these purposes like an *79 agency of the government") (citations and internal quotation marks omitted).

This case is also distinguishable from *LTV Corp.* and *Velazquez* because the SEC—the agency with " 'plenary authority' to supervise the SIPC," *Barbour*, 421 U.S. at 417, 95 S.Ct. 1733—has proffered a competing view of

the meaning of the statute. The Trustee and SIPC suggest, however, that the SEC's oversight and rule-making authority has somehow atrophied because, in the over thirty years since SIPA's creation, it has never been exercised meaningfully. Harbeck Letter at 2. While the SEC's historically *laissez-faire* approach to its SIPA responsibilities is relevant to our deference analysis, *see infra* at 80–83, we do not believe it has effected the shift in the balance of power between the two organizations that SIPC and the Trustee seem to envision.¹⁴

[2] In *Chao v. Russell P. Le Frois Builder, Inc.*, 291 F.3d 219 (2d Cir.2002), we addressed a similar problem where "two administrative agents"—the Secretary of Labor and the Occupational Safety and Health Review Commission—offered competing views of the statute at issue. *Id.* at 226. We held that the very first step of that deference analysis required a choice between the two agencies: "For purposes of [the deference] analysis, then, we must first decide to which administrative actor—the Secretary or the Commission—Congress 'delegated authority ... to make rules carrying the force of law.' Only then can we decide the nature or extent of that deference." *Id.* (quoting *United States v. Mead Corp.*, 533 U.S. 218, 226–27, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001) (citation omitted)). While SIPC clearly plays an essential administrative role, Congress deliberately chose *not* to grant SIPC agency authority, *see* 15 U.S.C. § 78ccc(a)(1) (A), and instead invested "plenary authority" over SIPA with the SEC, *Barbour*, 421 U.S. at 417, 95 S.Ct. 1733. Thus, while SIPC's proposed construction of the statute is a relevant part of our analysis—and will certainly inform the level of deference we accord to the SEC's reading of the statute—it is not an interpretation to which we must necessarily defer.¹⁵ We confine our holding to the unique facts of this case where the SEC has offered a competing and more persuasive interpretation of the statute. We do not consider what measure of deference an SIPC interpretation might warrant under other circumstances, e.g., when it alone speaks to the meaning of one of its rules. Our decision in *Charisma Securities* left *80 that general question open and we do so here as well.

[3] Ultimately, we agree with the SEC that "[w]hatever SIPC's expertise in overseeing SIPA liquidations, Congress did not intend for the Commission's interpretations of SIPA to be overruled by deference to the entity that was made subject to the Commission's oversight." Prezioso Letter at 8. The SEC has also highlighted that, under the statutory scheme, if SIPC filed a proposed rule that set forth its current interpretation of section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1), the Commission would, after considering whether the proposed

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rule was consistent with SIPA and in the public interest, have authority to deny approval of such a rule. *Id.* Even more compelling, the SEC argues that it could require SIPC to adopt a rule that sets forth what the SEC believes is the appropriate interpretation of section 9(a)(1). *Id.* We agree that deference to SIPC, under the circumstances presented here, would impermissibly undermine that statutory hierarchy. Whether the SEC interpretation of section 9(a)(1) deserves deference from this Court is a separate question to which we now turn.

III. THE SEC'S INTERPRETATION IS PERSUASIVE AND MERITS *SKIDMORE* DEFERENCE

A. Mandatory *Chevron* Deference Is Unwarranted in this Case

[4] The first question we must ask in the deference analysis is "whether Congress has directly spoken to the precise question at issue." *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984). Of course, if congressional intent could be discerned from the face of SIPA, our deference inquiry would be over because "the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Id.* at 842-43, 104 S.Ct. 2778; see also *United States v. Galt*, 342 F.3d 89, 92 (2d Cir.2003) ("Statutory construction begins with the plain text and, if that text is unambiguous, it usually ends there as well."). SIPA does not address the precise issue presented in this case. The statute fails to provide any definition of a "claim for cash." See 15 U.S.C. § 78fff. None of the provisions outlines how the Claimants—who were fraudulently misled to "invest" their money in Goren's bogus securities—should be treated. This is precisely the type of "interstitial" question anticipated by *Chevron* and its progeny. See, e.g., *Barnhart v. Walton*, 535 U.S. 212, 222, 122 S.Ct. 1265, 152 L.Ed.2d 330 (2002).

[5] In light of the statute's silence, and because we have an agency interpretation of section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1), the second *Chevron* step requires that, as opposed to proceeding to construe the statute ourselves (as we usually would), we must determine whether the SEC's interpretation "is based on a permissible construction of the statute." *Chevron*, 467 U.S. at 843, 104 S.Ct. 2778. "If the administrator's reading fills a gap or defines a term in a way that is reasonable in light of the legislature's revealed design, we give the administrator's judgment 'controlling weight.'" *NationsBank of North Carolina, N.A. v. Variable Annuity Life Ins. Co.*, 513 U.S. 251, 257, 115 S.Ct. 810, 130 L.Ed.2d

740 (1995) (quoting *Chevron*, 467 U.S. at 844, 104 S.Ct. 2778); see also *SEC v. Zandford*, 535 U.S. 813, 819-20, 122 S.Ct. 1899, 153 L.Ed.2d 1 (2002) (explaining that SEC's interpretation of "the ambiguous text of § 10(b) ... is entitled to deference if it is reasonable").

There are several reasons that the mandatory deference envisioned by *Chevron* would be inappropriate here. First, although the SEC has clearly had the power *81 to draft rules to address this ambiguity in SIPA, the interpretation proffered in its brief has never been articulated in any rule or regulation.¹⁶ As the SEC admits, "[o]ther than the Series 500 Rules, which the Commission does not interpret to cover fictitious securities, the Commission has not defined by regulation the terms in Section 9(a)." Prezioso Letter at 6. In *United States v. Mead Corp.*, 533 U.S. 218, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001), the Supreme Court explained that it "ha[s] recognized a very good indicator of delegation meriting *Chevron* treatment in express congressional authorizations to engage in the process of rulemaking or adjudication that produces regulations or rulings for which deference is claimed." *Id.* at 229, 121 S.Ct. 2164 (emphasis added). While the fact that the SEC interpretation has not been expressed in the form of a rule or regulation crafted after notice and comment does not alone determine the applicability of *Chevron*, see *id.* at 230-31, 121 S.Ct. 2164; *Walton*, 535 U.S. at 222, 122 S.Ct. 1265, taken together with the factors discussed *infra*, it counsels against affording *Chevron* deference to the SEC's interpretation.

Second, it appears that the position taken by the SEC in its brief is one that it has not previously articulated in any form. Cf. *Local 705, Int'l Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 566 & n. 20, 99 S.Ct. 790, 58 L.Ed.2d 808 (1979) (noting that "considerable weight" is given to "an administrative agency's consistent, longstanding interpretation of the statute under which it operates") (emphasis added). To be clear, while the SEC's articulation of this position is new, the issue certainly is not. The SEC acknowledges that SIPC has long held its position regarding the treatment of non-existent securities. SIPC first articulated this argument—that a claim for fictitious securities is properly treated as a claim for cash—in cases that arose over a decade ago. See *Plumbers and Steamfitters Local 490 Severance and Ret. Fund v. Appleton (In re First Ohio Sec. Co.)*, No. 93-3313, 39 F.3d 1181 (table), 1994 WL 599433, at *1 (6th Cir. Nov.1, 1994) (unpublished decision) (finding that "the only legal conclusion possible" where claimants sought SIPC advances for securities that "never even existed" was that the

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claims were “for cash” and not “for securities”), *cert. denied*, 514 U.S. 1018, 115 S.Ct. 1362, 131 L.Ed.2d 219 (1995); *Appleton v. Hardy* (In re First Ohio Sec. Co.), No. 590–0072 (Bankr.N.D. Ohio Dec. 1, 1992) (unpublished order affirming trustee’s determination that a claim for non-existent securities is a “claim for cash”). SIPC also apprised the SEC of its position on this issue in its 1993 and 1994 Annual Reports. Harbeck Letter at 9.

Third, the SEC concedes that its new interpretation of SIPA has been expressed “for the first time ... in an *amicus* brief filed at the request of this Court” and that, under those circumstances, its interpretation “may not be entitled to *Chevron* deference.” Prezioso Letter at 6. As we observed in *Callaway v. Commissioner*, 231 F.3d 106 (2d Cir.2000), the Supreme Court has “accorded deference, even to agency interpretations appearing for the first time in an *amicus* brief, where there ‘is simply no reason to suspect that the interpretation does not reflect the agency’s fair and considered judgment on the matter in question.’” A new, and therefore inconsistent position, may yet be ‘fair and considered.’” *Id.* at 132 (citations omitted); see also *Cedar Rapids Cmty. Sch. Dist. v. *82 Garret F. ex rel. Charlene F.*, 526 U.S. 66, 74–75 n. 6, 119 S.Ct. 992, 143 L.Ed.2d 154 (1999); *Auer v. Robbins*, 519 U.S. 452, 462, 117 S.Ct. 905, 137 L.Ed.2d 79 (1997). But cf. *Christensen v. Harris County*, 529 U.S. 576, 587, 120 S.Ct. 1655, 146 L.Ed.2d 621 (2000) (“Interpretations such as those in opinion letters—like interpretations contained in policy statements, agency manuals, and enforcement guidelines, all of which lack the force of law—do not warrant *Chevron*-style deference.”). The SEC’s opinion is certainly not the sort of “‘post hoc rationalization’ ... to defend past agency action against attack” about which the Supreme Court has registered concern. *Auer*, 519 U.S. at 461–62, 117 S.Ct. 905 (citation omitted). We have no reason to doubt that the SEC’s interpretation was the product of careful consideration. And the SEC’s familiarity with this case from its inception lends credence to its view. Nevertheless, the SEC submitted its brief only after being invited to do so (and only once this dispute reached appeal).¹⁷ Indeed, in some cases, we have declined to consider arguments raised for the first time in an appellate *amicus* brief. See, e.g., *Concourse Rehab. & Nursing Ctr., Inc. v. DeBuono*, 179 F.3d 38, 47 (2d Cir.1999). This, then, is another consideration that weighs against *Chevron* deference.

Finally, the SEC’s historical relationship with SIPC and SIPC’s arguably greater familiarity with the provisions of SIPA are yet additional reasons to decline to apply *Chevron*

deference to the SEC’s interpretation of SIPA. *Chevron* deference is predicated, in part, on the perceived superior expertise of the agency in question. See *Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 651–52, 110 S.Ct. 2668, 110 L.Ed.2d 579 (1990) (“[P]ractical agency expertise is one of the principal justifications behind *Chevron* deference.”). With respect to SIPA and the determinations made by the Trustee and SIPC during liquidation proceedings, the SEC’s role involves more removed oversight. Indeed, if the conduct of this litigation is any indication, it appears that the SEC generally adopts a hands-off approach with respect to SIPC liquidations (and litigation). As a result, the SEC’s “expertise” in this context is arguably less compelling than it would be with respect to those portions of the Securities Exchange Act as to which it takes a more proactive day-to-day role. Cf. *Bowen v. Am. Hosp. Ass’n*, 476 U.S. 610, 643 n. 30, 106 S.Ct. 2101, 90 L.Ed.2d 584 (1986) (noting that where the Department of Health and Human Services was one of twenty-seven agencies responsible for promulgating regulations forbidding discrimination, “there is ... not the same basis for deference predicated on expertise as we found [in *Chevron*]”).

For these reasons, we find that the “informal opinion” proffered by the SEC in its *amicus* brief “lacks the force of law” and thus does not warrant *Chevron* deference. *Chao*, 291 F.3d at 227.

B. *Skidmore* Deference Is Appropriate

[6] [7] The fact that *Chevron* is inapplicable to this case does not mean that the SEC’s interpretation will merit no deference. *83 whatsoever. Instead, it warrants the more limited standard of deference adopted by the Supreme Court in *Skidmore v. Swift & Co.*, 323 U.S. 134, 65 S.Ct. 161, 89 L.Ed. 124 (1944). See *United States v. Mead Corp.*, 533 U.S. 218, 234, 121 S.Ct. 2164, 150 L.Ed.2d 292 (2001) (“*Chevron* did nothing to eliminate *Skidmore*’s holding that an agency’s interpretation may merit some deference whatever its form, given the ‘specialized experience and broader investigations and information’ available to the agency.”) (quoting *Skidmore*, 323 U.S. at 139, 65 S.Ct. 161); *Eden v. Bank of Boston*, 229 F.3d 154, 169 n. 19 (2d Cir.2000), *cert. denied*, 531 U.S. 1061, 121 S.Ct. 674, 148 L.Ed.2d 652 (2001). As the *Skidmore* Court explained, the level of deference owed to any particular interpretation depends upon “the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.” 323 U.S. at

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140, 65 S.Ct. 161; see also *Mead*, 533 U.S. at 239, 121 S.Ct. 2164. In *Community Health Center v. Wilson-Coker*, 311 F.3d 132 (2d Cir.2002), we outlined the factors that inform our *Skidmore* analysis, including “the agency’s expertise, the care it took in reaching its conclusions, the formality with which it promulgates its interpretations, the consistency of its views over time, and the ultimate persuasiveness of its arguments.” *Id.* at 138, 65 S.Ct. 161.

Applying the *Community Health Center* factors in this case, we find that several factors—most notably the persuasiveness of the SEC’s interpretation—weigh in favor of deference to the SEC’s reading of section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1). Under the federal securities laws, the SEC is responsible for regulating broker-dealers, administering the securities exchanges and protecting the public interest. The protections outlined in SIPA are merely one aspect of this much broader legislative scheme. Although the SEC has not always played a direct role in administering SIPA, its general oversight of the securities laws gives it expertise that merits some degree of deference. We decline to accord the SEC interpretation the “considerable deference” it requests, because the SEC has not had the kind of history of consistent interpretation of section 9(a)(1) that prompted our holding in *Community Health Center*. See 311 F.3d at 139. As we did in *Community Health Center*, we decline to determine “the exact molecular weight of the deference” to be accorded to the SEC’s position without analyzing the persuasiveness of its interpretation (the final *Skidmore* factor). *Id.* at 137–38, 65 S.Ct. 161.

C. The SEC’s “Claims for Securities” Analysis Is Persuasive

The SEC disagrees with SIPC’s “claims for cash” analysis, asserting that the mere fact that the Claimants’ net equity is determined by the amount of cash paid for the securities does not mean that the Claimants have claims for cash within the meaning of section 9(a)(1). *Br. for Amicus Curiae SEC* at 17. Although it notes that the “SIPC’s desire for cash-versus-securities consistency among the various provisions [of SIPA] is not an unreasonable approach,” the SEC argues that the provisions relied upon by SIPC to supply this definition do not mention the terms “claim for cash” or “claim for securities.” *Id.* at 14. In fact, the “net equity” definition, see 15 U.S.C. § 78lll (11), upon which SIPC heavily relies, does not even use the word “cash.” None of the provisions relied upon by SIPC illuminate the definition of a “claim for cash.”

1. The SEC’s Interpretation Furthers SIPA’s Investor Protection Goals

[8] Examination of SIPA’s legislative history reveals that the SEC’s interpretation *84 is better tailored to the original aims of SIPA’s drafters. Congress enacted SIPA in 1970, in response to “a rash of failures among securities broker-dealers in the late 1960s” that had resulted in “significant losses to customers whose assets either were unrecoverable or became tied up in the broker-dealers’ bankruptcy proceedings.” *Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 222 F.3d 63, 66 (2d Cir.2000). The statute was “designed to effect two aims.” H.R. REP. NO. 91–1613, at 2–4 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5257. First, the legislation immediately established “a substantial reserve fund ... [to] provide protection to customers of broker-dealers ... to reinforce the confidence that investors have in the U.S. securities markets.” *Id.* Second, SIPA “strengthen[ed] ... the financial responsibilities of broker-dealers.” *Id.* Later amendments to the statute have reiterated this emphasis on investor protection. In 1978, the statute was amended to, *inter alia*, “increase[] the amounts available to be distributed in liquidations to each customer from \$50,000 to \$100,000; no more than \$40,000 (instead of the present \$20,000) is available to satisfy claims for cash.”¹⁸ S. REP. NO. 95–763, at 2 (1978), *reprinted in* 1978 U.S.C.C.A.N. 764, 765. These and other changes included in the 1978 amendments were intended to address the perceived “limitations ... upon SIPC’s ability to provide the type and degree of protection for securities customers for which SIPA was enacted. Specifically, these limitations in some cases impair the satisfaction of customers’ claims as fully, promptly and efficiently as the Committee believes is desirable.” *Id.* These statutory goals—promoting investor confidence and providing protection to investors—are better served by the SEC’s broader reading of section 9(a)(1).¹⁹ See *Tcherepnin v. Knight*, 389 U.S. 332, 336, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967) (“We are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes.”) (interpreting the 1934 Securities Exchange Act).

2. The Legislative History of Section 9(a)(1) of SIPA Supports the SEC’s Interpretation

The distinction between “claims for cash” and “claims for securities” in section 9(a)(1) was introduced into SIPA shortly before the legislation was passed. It appears to have been intended to address concerns raised during the drafting

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process by the Department of the Treasury and the Board of Governors of the Federal Reserve. In April 1970, the Acting General Counsel of the Department of the Treasury *85 sent letters to the chairmen of the relevant committees of both the Senate and the House stating that Treasury opposed the bills, in part because the proposed limit on cash advances of \$50,000 per account far exceeded the \$20,000 limit per account on coverage provided by FDIC and FSLIC, and, thus, "could be construed as an indication that the Federal Government attaches greater importance to the preservation of public confidence in broker-dealers than to the preservation of confidence in the banking system."²⁰ *Federal Broker-Dealer Insurance Corporation: Hearings on S. 2348, 3988 and 3989 Before the Subcomm. on Sec. of the Senate Comm. on Banking and Currency*, 91st Cong. 79-80 (1970) (letter from Englert to Sparkman); *Securities Investor Protection: Hearings on H.R. 13308, 17585, 18081, 18109 and 18458 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce*, 91st Cong. 148-49 (1970) [hereinafter *House Subcommittee Hearings*] (letter from Englert to Staggers). The Vice Chairman of the Board of Governors of the Federal Reserve System made a similar observation—that the proposed SIPC "insurance" would be "more generous than coverage afforded depositors" under the FDIC and FSLIC—in a July 1970 letter to the House Committee. *House Subcommittee Hearings, supra*, at 145-47 (letter from Robertson to Staggers). He indicated, however, that the Federal Reserve Board recognized that "coverage of customers of broker-dealers cannot be entirely parallel to that afforded depositors in banks, because the broker performs a custodial function—as an integral part of customer account services—in holding customers' fully paid securities in safekeeping." *Id.* He proceeded to explain that "[t]he accounts of customers of broker-dealers thus reflect partly depository claims (credit balances) comparable to claims insured by the FDIC and partly custodial claims comparable not to deposits but to bank trust accounts." *Id.*

Notwithstanding this disparity, both bills emerged from their respective committees without modification of the \$50,000 limit, see 116 CONG. REC. 39,358 (Dec. 1, 1970) (draft of H.R. 19333, 91st Cong. § 6(e)(1) (1970)); *id.* at 40,865-66 (Dec. 10, 1970) (draft of S. 2348, 91st Cong. § 35(m)(11) (1970)), and the House bill containing the \$50,000 limit was passed on December 1, 1970, *id.* at 39,369-70. At a December 10 debate, however, the Senate adopted an amendment proposed by Senators McIntyre and Muskie to reduce the "maximum insurance-type protection" for all SIPA claims from \$50,000 to \$20,000 in order to "bring investor protection

in line with the protections which the Congress has already made available to depositors in banks and shareholders in savings and loan associations." *Id.* at 40,872 (statement of Sen. McIntyre). Another senator, after observing that it was reasonable to reduce the "coverage for cash" to \$20,000 to "bring[] it in line with the insurance coverage for cash deposits" in other institutions, inquired whether "it might be more acceptable and more efficient in restoring confidence if the figure in the original bill with respect to securities only were left at \$50,000 and the \$20,000 applied to the cash." *Id.* (statement of Sen. Bennett). After considerable debate, the Senate passed the amended version—reducing *86 all claims to \$20,000—but with an understanding that the issue of a provision with separate limits for cash and securities would receive further examination in conference. *Id.* at 40,873-77.

Shortly thereafter, the Conference Committee reported that it had adopted the two-tiered system envisioned during the Senate debates, distinguishing the amount of protection available for securities claims from that available for cash claims. CONF. REP. NO. 91-1788, at 3 (1970), *reprinted in* 1970 U.S.C.A.N. 5281, 5283 ("The Conference substitute continues the \$50,000 limitation, but provides further that, insofar as all or any portion of a customer's claim is for cash (as distinct from securities), the amount advanced for such claim to cash shall not exceed \$20,000."). The revised bill (H.R. 19333) was passed by both chambers and signed into law on December 30, 1970.

[9] In light of this history, we are persuaded by the SEC's view that the dichotomy between "claims for cash" and "claims for securities" in section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1), was introduced "to distinguish the custodial functions of a broker-dealer with respect to securities from the broker-dealer's depository-like functions with respect to cash deposits." *Br. for Amicus Curiae SEC* at 12. The "claims for cash" carve-out in section 9(a)(1) "was intended to ... limit the protection of a brokerage firm customer who uses his account as a depository for cash to the same protection for that cash that bank depositors receive under FDIC coverage." *Id.* Adopting this view of the statute, we find that because the Claimants directed that the money they placed with the Debtors be used to purchase securities—and, importantly, because they received confirmations and account statements reflecting such purchases—they are not the types of cash depositors envisioned by the drafters of the "claims for cash" provision.

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3. The Series 500 Rules Support an Outcome Based on the Claimants' Legitimate Expectations

As a final source of support for its position, the SEC cites the Series 500 Rules. Under the Series 500 Rules, whether a claim is treated as one for securities or cash depends not on what is *actually* in the customer's account but on what the customer has been told by the debtor in written confirmations. Thus, if the debtor sends a written confirmation to the customer that the securities in the customer's account have been sold, then the customer has a "claim for cash," even if the sale never took place (unless there is a contract for the sale). 17 C.F.R. § 300.501(a). The customer is also viewed as having a "claim for cash" even if he or she placed an order for the purchase of securities unless (i) the debtor has sent a written confirmation of the purchase; or (ii) the securities have become "the subject of a completed or executory contract for purchase." 17 C.F.R. § 300.501(b). Conversely, another rule makes clear that if the customer's account actually holds cash but the customer received from the debtor a written confirmation of a securities purchase, then the customer has a "claim for securities" in the liquidation. 17 C.F.R. § 300.502(a)(1).

[10] The Claimants assert that "the Series 500 rules, by their plain language, unambiguously apply to the classification issue presented here." Wissner-Gross Letter at 2. While the Claimants are correct that the Series 500 Rules address the circumstance of non-existent *transactions*, there is nothing in the rules suggesting their applicability to cases involving non-existent *securities*. The SEC and SIPC both indicate that the Rules were promulgated to resolve whether a claim is for *87 securities or cash when a transaction in real securities straddled the filing date and do not govern transactions involving fictitious securities, and we defer to their shared interpretation because we do not find that it is "plainly erroneous or inconsistent with" the Series 500 Rules. *Bowles v. Seminole Rock & Sand Co.*, 325 U.S. 410, 414, 65 S.Ct. 1215, 89 L.Ed. 1700 (1945) (explaining that agency's interpretation of its own regulations is "of controlling weight unless it is plainly erroneous or inconsistent with the regulation"); see also *Auer v. Robbins*, 519 U.S. 452, 461, 117 S.Ct. 905, 137 L.Ed.2d 79 (1997) (same).

Nevertheless, we are persuaded by the SEC's argument that the premise underlying the Series 500 Rules—that a customer's "legitimate expectations," based on written confirmations of transactions, ought to be protected—supports the SEC's interpretation of section 9(a)(1). See Rules of the Sec. Investor Prot. Corp., 53 Fed.Reg. 10368–69 & n.

3 (Mar. 31, 1988). In the SEC's view, the Claimants in this case should be treated as having claims for securities because the confirmations and account statements that they received from the Debtors stated that the Claimants held securities in their accounts. *Br. for Amicus Curiae SEC* at 8.

SIPC disputes that customers can have "legitimate" expectations as to non-existent securities. We note that SIPC's approach does perhaps promote an arguably laudable policy goal—encouraging investors to research and monitor their investments (and their brokers) with greater care. This goal of greater investor vigilance, however, is not emphasized in the legislative history of SIPA. Instead, as outlined *supra* at [26–27], the drafters' emphasis was on promoting investor confidence in the securities markets and protecting broker-dealer customers. We find the SEC's interpretation more in line with the goals of the statute and with the legislators' intent in introducing the securities/cash distinction in section 9(a)(1).

After reviewing the language of the statute, its purposes of protecting investors and inspiring confidence in the securities markets, and the specific history surrounding the drafting of the relevant language found in section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1), we are persuaded by and, thus, defer to the SEC's interpretation. Indeed, even if we were not to adopt the SEC's interpretation as a matter of *Skidmore* deference, we would independently conclude that it is the proper interpretation of the statute. As the SEC explains:

When a customer has been sent confirmations and account statements reflecting his securities purchases and showing that he holds the securities in his account, his claim, in the Commission's view, involves the debtor's function as securities custodian and is one for securities entitled to SIPC protection up to \$500,000. Conversely, if the customer is using his brokerage account as a cash depository, as reflected in his account statements, he has a claim for cash entitled to protection up to \$100,000—no more protection than that provided to bank depositors.

Br. for Amicus Curiae SEC at 12–13.

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D. The Claims Should Be Valued According to the Amount Initially Paid by the Claimants to the Debtors for the Purchase of the New Age Funds and Should Not Include Fictitious Interest or Dividend Reinvestments

[11] Finally, we must consider how the Claimants' net equity under SIPA should be determined. The District Court made this calculation by relying on the "value" of the bogus securities (including artificial interest *88 and dividends) as set forth in the fictitious account statements that the Claimants received from Goren and the Debtors. See *SEC v. Goren*, 206 F.Supp.2d 344, 352 (E.D.N.Y.2002). The District Court defended this calculation as necessary to protect the Claimants' "legitimate expectations." *Id.* at 351.

The SEC and SIPC are in agreement that the Claimants' net equity should be valued according to the cash they initially provided to the Debtors to purchase the Funds and should not include any bogus interest or dividend reinvestments. Cf. *SEC v. Aberdeen Sec. Co., Inc.*, 480 F.2d 1121, 1127-28 (3d Cir.) (explaining that a customer's net equity includes cash that the broker should have been holding on the filing date), *cert. denied sub nom. Seligson v. SEC*, 414 U.S. 1111, 94 S.Ct. 841, 38 L.Ed.2d 738 (1973); *Focht v. Athens (In re Old Naples Sec., Inc.)*, No. 2:00-cv-181-FTM-29D, slip op. at 15-17 (M.D.Fla. Sept. 30, 2002) (calculating net equity according to claimants' initial investment in Ponzi scheme and offsetting that number by any phony interest payments received). As the SEC indicated in its brief, basing customer recoveries on "fictitious amounts in the firm's books and records would allow customers to recover arbitrary amounts

that necessarily have no relation to reality.... [and] leaves the SIPC fund unacceptably exposed." Br. for *Amicus Curiae* SEC at 16. SIPC and the SEC agree that such an approach is irrational and unworkable and we defer to their unanimous and persuasive analysis of the potential absurdities created by reliance on the entirely artificial numbers contained in fictitious account statements. Accordingly, we adopt the view that the Claimants' net equity is properly calculated as the amount of money that the Claimants initially placed with the Debtors to purchase the New Age Funds and does not include the artificial interest or dividend reinvestments reflected in the fictitious account statements that the Claimants received from the Debtors.

CONCLUSION

For the foregoing reasons, we affirm the District Court's determination that the Claimants have "claims for securities" under section 9(a)(1) of SIPA, 15 U.S.C. § 78fff-3(a)(1), but we vacate the District Court's calculation of the value of those claims and remand for further proceedings consistent with this opinion. The judgment of the District Court is hereby affirmed in part and vacated and remanded in part and the Claimants-Appellees may recover two-thirds of their costs on this appeal.

All Citations

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Footnotes

- * The Honorable David N. Hurd, United States District Judge for the Northern District of New York, sitting by designation.
- 1 The parties do not dispute the underlying facts of this case.
- 2 Goren used some of this money to pay "dividends" on prior investments. Goren's fraud was, thus, a classic "Ponzi scheme," where money contributed by his later customers was paid out as "artificially high dividends for the original investors," which, in turn, attracted additional customers and investments. BLACK'S LAW DICTIONARY 1180 (7th ed.1999) (explaining that, in a Ponzi scheme, "[m]oney from the new investors is used directly to repay or pay interest to old investors, usually without any operation or revenue-producing activity other than the continual raising of new funds"); see also *United States v. Moloney*, 287 F.3d 236, 242 (2d Cir.), *cert. denied*, 537 U.S. 951, 123 S.Ct. 416, 154 L.Ed.2d 297 (2002).
- 3 Formed pursuant to SIPA, SIPC is a "nonprofit, private membership corporation to which most registered brokers and dealers are required to belong." *Sec. Investor Prot. Corp. v. Barbour*, 421 U.S. 412, 416, 95 S.Ct. 1733, 44 L.Ed.2d 263 (1975) (citing 15 U.S.C. § 78ccc). SIPC "monitors the activities of broker-dealers and insures customers in the case of a broker-dealer's liquidation." *Sec. Investor Prot. Corp. v. BDO Seidman, LLP*, 222 F.3d 63, 66 (2d Cir.2000).
- 4 SIPA defines a "security" as "any note, stock, ... bond, debenture, evidence of indebtedness, ... transferable share, ... certificate of deposit, certificate of deposit for a security, any investment contract or certificate of interest or participation in any profit-sharing agreement, ... any put, call, straddle, option, or privilege on any security, or group or index of securities

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(including any interest therein or based on the value thereof), ... and any other instrument commonly known as a security." 15 U.S.C. § 78fff (14). According to the District Court, "SIPC considers shares in money market funds organized as mutual funds to be securities, provided those shares are held in customers' securities accounts." *SEC v. Goren*, 206 F.Supp.2d 344, 350 (E.D.N.Y.2002).

In this case, the SIPA "filing date" was February 17, 2000, the date that the SEC filed the initial complaint against Goren and the Debtors. See 15 U.S.C. § 78fff (7).

5 As of December 31, 2002, the SIPC fund was valued at \$1.26 billion. See SEC. INVESTOR PROT. CORPP., 2002 ANNUAL REPORT 8, available at http://www.sipc.org/pdf/SIPC_Annual_Report_03.pdf. Since 1996, SIPC members have been assessed \$150 per year. *Id.* at 9. In prior decades, assessment rates fluctuated annually depending on SIPC's expenses during the prior year. See *id.*; see also 15 U.S.C. § 78ddd(d)(1).

6 The parties do not dispute that because the securities at issue in this case never existed, no substitute or replacement securities exist and the Claimants must be paid in cash. Cf. 15 U.S.C. §§ 78fff-1(b)(1), 78fff-2(b), 78fff-3(a).

7 Some of the Claimants also made (or at least believed they had made) other investments through Goren but those investments, which were treated as "claims for securities" by the Trustee, are not the subject of this appeal.

8 As outlined *infra* at 86-87, the Series 500 Rules provide guidance for determining whether a customer has a cash claim or a securities claim when a relevant transaction straddled the filing date. The customer's "legitimate expectations" are the focus of the rule, which makes the cash/securities determination largely dependent on the receipt of written confirmations. SIPC and the Trustee submitted joint briefs.

10 The Claimants assert that, as the District Court found, the Series 500 Rules do dictate the result in this case and Claimants' net equity should be calculated by reference to the fictitious account statements they received from the Debtors.

11 We note, however, that SIPC's and the SEC's failure to come to consensus with respect to the issues presented on this appeal seems a far cry from the "cooperation and coordination" anticipated by SIPA's drafters. H.R. REP. NO. 91-1613, at 12 (1970), reprinted in 1970 U.S.C.A.N. 5254, 5266 ("Only with cooperation and coordination between the efforts of the self-regulatory organizations, SIPC and the Commission, can this legislation see its fullest effectiveness.").

12 The Claimants assert that this dispute about whether the SEC or SIPC is owed deference is moot because the Series 500 Rules directly resolve this claim classification issue. Letter from Wissner-Gross, on behalf of the Claimants, to the Court of 7/3/03, at 7-8 ("Wissner-Gross Letter"). As outlined *infra* at 86-87, in light of the persuasive SIPC and SEC analyses to the contrary, we disagree with the District Court's conclusion (and the Claimants' argument) that the Series 500 Rules govern this case and find, instead, that the Series 500 Rules were adopted to deal with transactions involving real, not fictitious, securities. We do, however, agree with the SEC's view that the Rules can be read broadly to support the SEC's reading of the remedial purposes of SIPA.

13 SIPC highlights the fact that, four years after *Charisma Securities* was decided, "Congress amended SIPA to instruct the courts to place 'considerable reliance' on SIPC's views" in determining appropriate trustee fee allowance amounts (the issue from *Charisma Securities*). Harbeck Letter at 8. We find that amendment cuts both ways. While it certainly explicitly expands the authority of SIPC, it does so *only* with respect to allowance determinations, an issue that is not presented in this case.

14 The SEC certainly cannot be characterized as having engaged in the "substantial supervision" of SIPC that was anticipated by the statute's drafters. *Barbour*, 421 U.S. at 419, 95 S.Ct. 1733. We do note, however, that in recent years, the SEC has been making efforts to improve its oversight of SIPC. See U.S. GENERAL ACCOUNTING OFFICE, PUB. NO. GAO-01-653, SEC. INVESTOR PROT.: STEPS NEEDED TO BETTER DISCLOSE SIPC POLICIES TO INVESTORS 10, 53-59, 87 (2001) (noting that SEC has begun monitoring SIPC liquidations more closely), available at <http://www.gao.gov>; 2003 GAO REPORT at 3, 13-14 (noting that SEC has broadened the sample of SIPC liquidations it reviews and that SEC has modified internal procedures to make its review of SIPC more streamlined).

15 Although *Chao* involved two agencies that naturally begin on more equal footing in a deference analysis, the shared responsibility for rule-making under SIPA—and the SEC's relative non-involvement historically—arguably makes this deference choice a closer call than that presented in *Chao*. See *Chao*, 291 F.3d at 226. Even if we were to find that *Chao* did not require this threshold choice—and that we could somehow manage the analytical awkwardness of a side-by-side deference analysis—we would reach the same ultimate result because we find the SEC's interpretation to be more persuasive than that offered by SIPC. See *infra* at 83-87.

16 We agree with the SEC and SIPC that the Series 500 Rules do not govern this issue. Even if we were to view the text of the Series 500 Rules as ambiguous, we would defer to the SEC's and SIPC's common interpretation.

17 The SEC asserts, however, that its "prior silence" should not preclude deference to its interpretation of SIPA because "[u]ntil this Court's request for an amicus brief, the Commission has never been asked to interpret Section 9(a) with

In re New Times Securities Services, Inc., 371 F.3d 68 (2004)

Fed. Sec. L. Rep. P 92,838, 43 Bankr.Ct.Dec. 45

- respect to fictitious securities." Prezioso Letter at 9. We are not persuaded by this explanation for the SEC's silence because the statute explicitly allows SEC intervention and participation in any SIPC proceeding (and does not require the SEC to await an invitation from the court or the parties). See 15 U.S.C. § 78eee(c).
- 18 These numbers were increased to their current levels in 1980. See Amendments to the Securities Investor Protection Act, Pub.L. No. 96-433, § 1, 94 Stat. 1855 (1980).
- 19 SIPC emphasizes that the only two authorities that seem to be directly on point (both of which, we note, are unpublished and cursory) support its position. See *Plumbers and Steamfitters Local 490 Severance and Ret. Fund v. Appleton* (*In re First Ohio Sec. Co.*), No. 93-3313, 39 F.3d 1181 (table), 1994 WL 599433, at *1 (6th Cir. Nov. 1, 1994) (unpublished decision), *cert. denied*, 514 U.S. 1018, 115 S.Ct. 1362, 131 L.Ed.2d 219 (1995); *Appleton v. Hardy* (*In re First Ohio Sec. Co.*), No. 590-0072 (Bankr.N.D. Ohio Dec. 1, 1992). While SIPC relies heavily on the Third Circuit's 1973 decision in *SEC v. Aberdeen Securities Co., Inc.*, 480 F.2d 1121 (3d Cir.), *cert. denied sub nom. Seligsohn v. SEC*, 414 U.S. 1111, 94 S.Ct. 841, 38 L.Ed.2d 738 (1973), that decision—which holds that in a case involving non-existent securities, the claimant is entitled to the "cash which the broker has, or should have, been holding," *id.* at 1127—does not resolve the issue of the applicability of the then-\$20,000 limit on "claims for cash." Clearly, however, the caselaw on this issue is sparse. We do not find these authorities particularly enlightening.
- 20 Apparently, the Department of the Treasury later changed its position. In a December 8, 1970 letter to the Chairman of the Senate Banking and Currency Committee, the Acting Secretary of the Treasury emphasized the Administration's support for S. 2348 and urged its prompt passage. 116 CONG. REC. 40,870 (1970) (letter from Walker to Sparkman).

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EXHIBIT B

In re New Times Securities Services, Inc., 463 F.3d 125 (2006)
 47 Bankr.Ct.Dec. 13, 52 A.L.R. Fed. 2d 681

 KeyCite Yellow Flag - Negative Treatment
 Declined to Extend by In re Lehman Bros. Inc., S.D.N.Y., February
 26, 2014

463 F.3d 125
 United States Court of Appeals,
 Second Circuit.

In re NEW TIMES SECURITIES
 SERVICES, INC., and NEW AGE
 FINANCIAL SERVICES, INC., Debtors,
 Mary Ann Stafford, Rheba Weine,
 Joel Weine, Plaintiffs-Appellees,
 v.

James Giddens, as Trustee for the Liquidation
 of the Substantially Consolidated Estates of
 New Times Securities Services, Inc. and New
 Age Financial Services, Inc., Securities Investor
 Protection Corporation, Defendants-Appellants.

Docket No. 05-5527-BK. | Argued:
 April 21, 2006. | Decided: Sept. 7, 2006.

Synopsis

Background: Securities Investor Protection Corporation (SIPC) and trustee under Securities Investor Protection Act (SIPA) filed joint motion in liquidation proceeding under SIPA to uphold trustee's determinations to deny certain claims treatment as customer net equity claims. The United States Bankruptcy Court for the Eastern District of New York, Melanie L. Cyganowski, J., granted motion, 318 B.R. 753. Claimants appealed. The United States District Court for the Eastern District of New York, JoAnna Seybert, J., 337 B.R. 259, reversed judgment of bankruptcy court. SIPC and trustee appealed.

[Holding:] The Court of Appeals, Jacobs, Circuit Judge, held that claimants who originally deposited funds with debtors for purchase of securities but who were defrauded by broker were not "customers" under SIPA.

Reversed and remanded.

Attorneys and Law Firms

*126 James B. Kobak, Jr. (Christopher K. Kiplok, on the brief), Hughes Hubbard & Reed LLP, New York, NY, for Defendant-Appellant James W. Giddens as Trustee for the Liquidation of the Businesses of New Times Securities Services, Inc., and New Age Financial Services, Inc.

Christopher H. Larosa, Assistant General Counsel (Josephine Wang, General Counsel, on the brief), Securities Investor Protection Corp., Washington, DC, for Defendant-Appellant Securities Investor Protection Corp.

May Orenstein (Sigmund Wissner-Gross, on the brief), Brown, Rudnick, Berlack, Israels LLP, New York, NY, for Plaintiffs-Appellees.

Before: WALKER, Chief Judge, JACOBS, and WALLACE,* Circuit Judges.

Opinion

JACOBS, Circuit Judge.

In the wake of the bankruptcy of two brokerage houses¹, plaintiffs-appellees Maryann Stafford and Rheba and Joel Weine ("plaintiffs") claimed an entitlement as "customers"-as defined by the Securities Investor Protection Act, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA" or the "Act")-to recover their losses from the funds SIPA reserves for such customers. The brokerage houses were instrumentalities of a Ponzi scheme engineered by their principal, William Goren; the plaintiffs, who were among the victims, had had accounts at the brokerage houses that contained substantial (but illusory) funds. The plaintiffs were induced to liquidate their accounts (in whole or in part) and make a loan of the imaginary funds to the brokerage houses and to Goren. The trustee for the SIPA liquidation of the brokerage houses ("Trustee") concluded that the plaintiffs were lenders, not "customers," and denied their claims to SIPA funds, and the United States Bankruptcy Court for the Eastern District of New York (Cyganowski, *B.J.*) agreed. The United States District Court for the Eastern District of New York (Seybert, *J.*) reversed, and this appeal is taken from that judgment by the Trustee and the Securities Investor Protection Corporation (the "SIPC"). We reverse, and remand to the district court with instructions to reinstate the judgment of the bankruptcy court.

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I

The facts of the case are undisputed. Goren conducted a Ponzi scheme using the two brokerage houses (the "Debtor"). He solicited investments in fictional money market funds; he pretended to invest in genuine money market funds; and he issued fraudulent promissory notes. See *In re New Times Sec. Servs., Inc.*, 371 F.3d 68, 71 (2d Cir.2004). In 1998, Stafford and the Weines invested (\$75,000 and \$35,000, respectively) with Goren for the purchase of securities. In 1999, they voluntarily authorized Goren to sell some or all of their securities accounts and reinvest the proceeds in interest-bearing promissory notes, with Goren and the Debtor as obligors.

On February 17, 2000, the SEC filed a complaint against the Debtor, and applied for orders freezing the Debtor's assets and appointing a temporary receiver. The district court granted the orders the next day. The statutory filing date for SIPA purposes is therefore February 17, 2000. See 15 U.S.C. § 78fff(7)(B). On that date, the plaintiffs were holding the promissory *127 notes. The Debtor was subsequently placed into SIPA liquidation, and the Trustee was appointed to oversee the liquidation under procedures established by the bankruptcy court.

The plaintiffs filed SIPA customer claims with the Trustee; the Trustee denied the claims insofar as they sought SIPA protection for the face amount of their promissory notes. The bankruptcy court affirmed the Trustee's rejection of the claims, holding that SIPA customer status is determined as of the filing date of a debtor liquidation and that the promissory notes held by plaintiffs at the filing date rendered them "lenders," not "customers," for SIPA purposes.² The district court reversed the bankruptcy court, on the ground that the plaintiffs' original securities investments with the Debtor established their status as "customers" and that their subsequent decision-fraudulently induced by Goren-to liquidate those securities investments and provide Goren and the Debtor with loans in exchange for promissory notes did not change their "customer" status.

II

We review *de novo* the district court's conclusions of law and its application of law to the undisputed facts. See *Pereira v. Farace*, 413 F.3d 330, 341 (2d Cir.2005).

"The principal purpose" of SIPA is "to protect investors against financial losses arising from the insolvency of their brokers." *SEC v. S.I. Salmon & Co.*, 375 F.Supp. 867, 871 (S.D.N.Y.1974). The Act advances this purpose by according those claimants in a SIPA liquidation proceeding who qualify as "customers" of the debtor priority over the distribution of "customer property."³ See 15 U.S.C. §§ 78fff-2(b) & (c)(1), 78fff(4). Each customer shares ratably in this fund of assets to the extent of the customer's net equity at the time of filing.⁴ See 15 U.S.C. § 78fff-2(c)(1)(B). If the fund of customer property is insufficient to make the customers whole, the government makes up the difference-subject to a cap-out of a special SIPC fund capitalized by the general brokerage community. See 15 U.S.C. §§ 78fff-3, 78ddd; see also *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 980 (2d Cir.1974).

"Judicial interpretations of 'customer' status support a narrow interpretation of the SIPA's provisions." *In re Stalvey & Assocs., Inc.*, 750 F.2d 464, 472 (5th Cir.1985) accord *In re Klein, Maus & Shire, Inc.*, 301 B.R. 408, 418 (Bankr.S.D.N.Y.2003) (collecting cases). "The Act contemplates that a person may be a 'customer' with respect to some of his claims for cash or shares, but not with respect to others." *SEC v. F.O. Baroff Co.*, 497 F.2d 280, 282 n. 2 (2d Cir.1974). A specific distinction is drawn between (i) "customers" and (ii) those in a lending relationship with the debtor (i.e., "lenders"):

*128 The term "customer" of a debtor means any person ... who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of its business as a broker or dealer from or for the securities accounts of such person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or for purposes of effecting transfer. The term "customer" includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purpose of purchasing securities, but does not include-

(B) any person to the extent that such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor

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15 U.S.C. § 78ll(2) (emphasis added); see also *Appleton v. First Nat'l Bank of Ohio*, 62 F.3d 791, 801 (6th Cir.1995) (stating that "[t]he critical aspect of the 'customer' definition is the entrustment of cash or securities to the broker-dealer for the purposes of trading securities.").

[1] That subsection (2), which was added to SIPA in 1978, see Pub.L. No. 95-283, 92 Stat. 249, thus distinguishes between (i) claimants (protected as customers) who are engaged through brokers in trading activities in the securities markets and (ii) those (unprotected) claimants who are relying on the ability of a business enterprise to repay a loan.⁵ "Lenders are simply not a class to be specially protected under SIPA and in fact were expressly excluded from the definition of customer upon the enactment of the 1978 amendments to SIPA." *In re Hanover Square Sec.*, 55 B.R. 235, 238-39 (Bankr.S.D.N.Y.1985). Whether an individual enjoys "customer" status thus turns on the transactional relationship. See *Baroff*, 497 F.2d at 284 (contrasting indicia of "the fiduciary relationship between a broker and his public customer" with characteristics of "an ordinary debtor-creditor relationship"). A loan transaction that is unrelated to trading activities in the securities market does not qualify for SIPA protection.

The SIPA scheme assumes that a customer-as an investor in securities-wishes to retain his investments despite the liquidation of the broker; the statute thus "works to expose the customer to the same risks and rewards that would be enjoyed had there been no liquidation." 6 Collier on Bankr.P 741.06[6] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev.); see also *In re Adler Coleman Clearing Corp.*, 195 B.R. 266, 274 (Bankr.S.D.N.Y.1996). It is a customer's legitimate expectations on the filing date—here, February 17, 2000—that determines the availability, nature, and extent of customer relief under SIPA. See 15 U.S.C. §§ 78fff-2(b), 78lll(7) & (11); see also *In re New Times Secs. Servs., Inc.*, 371 F.3d 68, 87 (2d Cir.2004) (suggesting that principle that a "customer's 'legitimate expectations,' *129 based on written confirmations of transactions, ought to be protected" informs interpretation of SIPA); *In re Stratton Oakmont*, 2003 WL 22698876, at *7 (S.D.N.Y. Nov. 14, 2003) ("[W]hether customers have claims for securities or for cash hinges on what they expected to have in their accounts on the filing date."); *Adler Coleman*, 195 B.R. at 274 ("[T]he Trustee must promptly deliver customer name securities to the debtor's customers as they are entitled to receive them and to distribute customer property and otherwise satisfy customer net equity

claims to the extent provided for in § 78fff."); S.Rep. No. 95-763, at 2 (1978), reprinted in 1978 U.S.C.A.N. 764, 765 ("By seeking to make customer accounts whole and returning them to customers in the form they existed on the filing date, the [1978] Amendments not only would satisfy the customers' legitimate expectations, but also would restore the customer to his position prior to the broker-dealer's financial difficulties.").

The promissory notes held by the plaintiffs on the filing date entitled them as holders to (i) a return of principal at a fixed time and (ii) interest at a fixed rate (18 percent); these are just the type of debt instruments whose possession brings claimants within the category of unprotected lenders.⁶ See *In re Mason Hill & Co.*, 2003 WL 23509197, at *4 (Bankr.S.D.N.Y. Dec.10, 2003) (denying SIPA "customer" status to holder of "essentially a promissory note"); *Hanover Square*, 55 B.R. at 238 (denying SIPA "customer" status to holders of subordinated loan agreements collateralized by securities).⁷

The district court concluded that because the plaintiffs were fraudulently induced to invest in the promissory notes, their legitimate expectations essentially froze at the moment that they sold their securities, and they therefore retain customer claims for "cash"—defined as money deposited with the broker (but not actually invested in securities).⁸ In reaching this conclusion, the district court relied on *In re New Times Securities Services*, in which customers deposited money with a broker for the purchase of securities that turned out to be wholly fictitious. 371 F.3d at 71-72. The *New Times* court determined that the customers had claims for securities, even though their "securities" were fictitious, because they had a legitimate expectation that they had invested in securities. See *id.* at 86 ("[W]e find that because the Claimants directed that the money they placed with the Debtors be used to purchase securities—and, importantly, because they received confirmations and account statements reflecting such purchases—they are not the types of cash depositors envisioned by the drafters of the 'claims for cash' provision."). Because there were no such securities, and it was therefore impossible to reimburse customers with the actual securities or their market value on the filing date (the usual remedies when customers hold specific securities), the *New Times* court determined that the securities should be valued according *130 to the amount of the initial investment. See *id.* at 87-88. The court declined to base the recovery on the rosy account statements telling customers how well the imaginary securities were doing, because treating the

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fictitious paper profits as within the ambit of the customers' "legitimate expectations" would lead to the absurdity of "duped" investors reaping windfalls as a result of fraudulent promises made on fake securities. See *id.*

[2] *New Times* does not support the plaintiffs' claims. In *New Times*, the customers were customers for securities because they had a legitimate belief that they were investing in securities. The court looked to the initial investment as the measure for reimbursement because the initial investment amount was the best proxy for the customers' legitimate expectations. In contrast, the plaintiffs here decided to swap their SIPA-protected securities investments for non-protected loan instruments. The plaintiffs authorized the loans, received confirmation and account statements indicating that they had made the loans (and referring to the instruments as "private notes"), and accepted interest payments in connection with the loans. Their only legitimate expectation must have been that they were lenders. True, they started as customers, and they would have been victimized in that status but for other fraudulently-induced transactions; so there is an unreal cast

to the transactions that altered the expectations that govern under SIPA. However, as noted *supra*, "customer status in the course of some dealings with a broker will not confer that status upon other dealings, no matter how intimately related, unless those other dealings also fall within the ambit of the statute." *In re Stalvey*, 750 F.2d at 471; see *Baroff*, 497 F.2d at 282 n. 2. The plaintiffs were defrauded by their broker, but "SIPA does not protect against all cases of alleged dishonesty and fraud." *In re Stratton Oakmont, Inc.*, 239 B.R. 698, 701-02 (S.D.N.Y.1999); see *S.I. Salmon & Co.*, 375 F.Supp. at 870-71.

The judgment of the district court is reversed, and the case is remanded to the district court with instructions to reinstate the judgment of the bankruptcy court.

All Citations

463 F.3d 125, 47 Bankr.Ct.Dec. 13, 52 A.L.R. Fed. 2d 681

Footnotes

- * The Honorable J. Clifford Wallace, United States Court of Appeals for the Ninth Circuit, sitting by designation.
- 1 *New Times Securities Services, Inc. and New Age Financial Services, Inc.*
- 2 The bankruptcy court noted that the Eastern District of New York had arrived at the same conclusion in a case involving litigants who also possessed the worthless promissory notes on the date of filing, but who had made those investments directly (and not with the proceeds from liquidation of their brokerage accounts). See *SEC v. Goren*, 00-CV-970/800-8178-288 (E.D.N.Y.2002) (Memorandum and Order).
- 3 SIPA defines "Customer Property" as "cash and securities ... at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted." 15 U.S.C. § 78fff(4).
- 4 SIPA defines "net equity" as "the dollar amount of the account or accounts of a customer." 15 U.S.C. § 78fff(11).
- 5 This distinction was first drawn in opinions by this court. See *Baroff*, 497 F.2d at 284; *Sec. Investor Prot. Corp. v. Exec. Sec. Corp.*, 556 F.2d 98, 99 (2d Cir.1977) (per curiam) ("Congress intended to protect the public customer 'as investor and trader, not ... others who might become creditors of the broker-dealer for independent reasons.' " (emphasis and alteration in original) (quoting *Baroff*, 497 F.2d at 283)). Apparently, through the passage of the 1978 amendments to SIPA, Congress "intended to codify decisions such as *Baroff* and *Executive Securities*." *In re Hanover Square Secs.*, 55 B.R. 235, 239 (Bankr.S.D.N.Y.1985) (citing to a 1978 Senate Committee hearing).
- 6 Plaintiffs do not contest that their investment in the promissory notes would normally bring them out of the ambit of SIPA "customer" status.
- 7 The district court agreed that "at the time of the filing date, [the plaintiffs] believed they were creditors, not customers."
- 8 Under SIPA, the only relevant difference between a customer claim for cash and a customer claim for securities is in the maximum limit that SIPC may advance to the SIPC trustee to satisfy customer claims that cannot be met from the customer property; the maximum for securities is \$500,000, see 15 U.S.C. § 78fff-3(a), while the maximum for cash is \$100,000, see § 78fff-3(a)(1). See *In re New Times Secs. Servs.*, 371 F.3d at 73.

PREPARED STATEMENT OF J.W. VERRET

ASSISTANT PROFESSOR OF LAW, GEORGE MASON SCHOOL OF LAW
SENIOR SCHOLAR, MERCATUS CENTER AT GEORGE MASON UNIVERSITY*

SEPTEMBER 30, 2015

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, I appreciate the opportunity to testify today on your Subcommittee's oversight of the Securities Investor Protection Corporation.

My name is J.W. Verret. I am an assistant professor of law at George Mason University Law School, where I teach corporate, securities, and banking law. I serve as a senior scholar at the Mercatus Center at George Mason University, and until recently I was Chief Economist and Senior Counsel at the House Committee on Financial Services.

The explosive growth in federally backed loan and guaranty programs has been an appropriate focus of congressional oversight in recent years. The Office of Management and Budget (OMB) estimates the Federal Government supports over \$3 trillion in loans and guarantees. Those loans and guarantees are often shrouded by indirect Government support and unreasonable assumptions in Government accounting practices.¹

I submit that the Securities Investor Protection Corporation's (SIPC) provision of securities custody insurance should be an appropriate part of that conversation. Government officials appoint SIPC directors and SIPC enjoys access to a \$2.5 billion line of credit with the Department of the Treasury. Some may argue that statutory language that "SIPC shall not be an agency or establishment of the United States Government" suggests otherwise.² We all recall how similar statutory language governing the Government-Sponsored Enterprises proved meaningless when those companies were placed in Federal conservatorship.

Today I will argue that privatization of SIPC is the best solution to protect American taxpayers, I will identify unexplored solutions for victims of Ponzi schemes. Though I argue privatization is the first best solution, I am glad to constructively engage in this Subcommittee's discussion about additional SIPC reforms.

REFORMING THE GOVERNMENT MONOPOLY

Most broker-dealers and members of national exchanges are required by statute to be members of SIPC, and SIPC is funded by assessments on its membership. SIPC thereby enjoys a statutory monopoly over the provision of securities custody insurance beneath the ceiling of its coverage.

Some of my fellow panelists may argue that SIPC serves an important role as a specialized liquidator of broker-dealers. Assuming that argument is true, it remains a tall leap of logic to further contend that a Government monopoly in the provision of securities custody insurance is thereby warranted.

SIPC's board is currently composed of private sector and Government members. I submit that privatization of SIPC's insurance function is the first best solution to the problems presented by the current structure of the SIPC. We might begin by lowering the ceiling of coverage.

I find it hard to accept that a market failure necessitates a Government monopoly in this space. In fact, there are underwriters at Lloyd's that sell "excess of SIPC" coverage for the portion of this market not crowded out by SIPC.³

In the absence of full privatization, the public-private composition of SIPC's board should not be viewed as a second best option. It would be better to officially recognize SIPC for the Government entity that it is, remove the private-sector board members, establish a similar level of congressional accountability for SIPC to that required of other Government agencies, and impose a term limit on its CEO.

THE PROBLEM OF PONZI SCHEME VICTIMS

The controversy and subsequent litigation between the SEC and SIPC with respect to the Allen Stanford Ponzi scheme, and issues with respect to Bernie Madoff victim claims, also suggest that a warning label should be provided as part of the legend describing SIPC coverage. This label would warn customers, "SIPC coverage only applies under limited circumstances, and SIPC reserves the right to deny

*The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

¹See, e.g., Federal Accounting Standards Advisory Board, "Memorandum: Public Hearing on Reporting Entity," August 20, 2013, http://www.fasab.gov/pdffiles/tab-a2_august-2013.pdf.

²Securities Investor Protection Act of 1970, 15 U.S.C. § 78ccc.

³TIAA-CREF, "SIPC and Excess of SIPC Asset Protection Guide," 2015, https://www.tiaa-cref.org/public/pdf/forms/SIPC_Reference_Guide_FINAL.pdf.

claims despite reasonable expectations of coverage.” SIPC won the Stanford litigation as a result of regrettable stipulations of fact by the SEC. In the related Madoff litigation, SIPC utilized an aggressive valuation methodology from among a range of methods used in prior cases.

My impression of both cases was that they were close calls that might have come out either way. It is nevertheless also clear to me that SIPC’s aggressive litigation position was designed to minimize claims to a fund that was unprepared for those claims, which suggests a clear conflict of interest for the receivers hired by SIPC and for SIPC itself.

I am not here today to re-litigate those cases or to endorse legislation that might ultimately result in new assessments by SIPC. I sympathize with the victims, and I recognize they have been subjected to unusually aggressive legal posturing by SIPC, but I worry about action that might only further entrench SIPC’s insurance monopoly.

I would suggest instead that this Subcommittee consider whether undistributed funds in the SEC’s Fair Funds program or in the Consumer Financial Protection Bureau’s settlement awards would better serve the purpose of making these victims whole.

I thank you for the opportunity to testify, and I look forward to answering your questions.

PREPARED STATEMENT OF JAMES W. GIDDENS

PARTNER, HUGHES HUBBARD & REED LLP, AND TRUSTEE, SIPA LIQUIDATIONS OF
LEHMAN BROTHERS INC. AND MF GLOBAL INC.

SEPTEMBER 30, 2015

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee: Thank you for inviting me to testify. My name is James Giddens, and I chair the Corporate Reorganization and Bankruptcy Group at Hughes Hubbard & Reed LLP. I have worked on issues related to the Securities Investor Protection Act (SIPA) for more than 45 years, most recently as the Trustee for the liquidations of Lehman Brothers Inc. and MF Global Inc.—the two largest liquidations under SIPA and two of the largest bankruptcies of any kind in history.

I welcome the opportunity to bring this experience and perspective to discuss how SIPA and the Securities Investor Protection Corporation (SIPC) have handled the most complex broker-dealer failures, as well as to submit for consideration areas for improvement in the statute and related laws and regulations.

Lehman Brothers Inc. SIPA Liquidation

Two weeks ago marked the seventh anniversary of Lehman’s collapse. Thus far, Lehman’s broker-dealer customers and creditors have received \$114 billion in distributions. This represents the largest distribution across the worldwide Lehman insolvency proceedings. Importantly, more than 110,000 retail customers, including mom-and-pop investors from all walks of life and from all across the country, received 100 percent of their property within days of the bankruptcy due to the unique account transfer process under SIPA.

This swift return of customer property was critical to restoring stability to the financial system during a time of great doubt and avoiding the potential for further financial collapse. The return of customer property could not have happened without SIPA’s account transfer provisions and the ability of the transfers to be backstopped by the SIPC fund. Indeed, it took hundreds of professionals working hand-in-hand with regulators to accomplish this extraordinary task and nearly 2 years to completely reconcile transferred accounts. A claims process for these accounts—the result in any other kind of bankruptcy proceeding—would have taken years longer.

At a recent court hearing, the Honorable Shelley Chapman, United States Bankruptcy Judge for the Southern District of New York, called the distributions “an incredibly extraordinary accomplishment in this case.” I, and, more importantly the customers and creditors who had their funds restored, agree.

MF Global Inc. SIPA Liquidation

When MF Global collapsed on Halloween of 2011 with revelations of more than \$1.6 billion of missing commodity customer property, a near full return of property to customers and creditors was doubtful. My counsel and I testified about the MF Global case before the full Senate Banking Committee, the Senate Agriculture Committee, the House Agriculture Committee, and the House Financial Services Committee. I am grateful for the support of all of these Committees as we worked under

SIPA to recover funds for customers and creditors, and together we achieved a favorable outcome for customers.

The efforts to recover property around the globe required scores of professionals, the invaluable assistance of U.S. regulators, and cooperation from foreign insolvency administrators. In conjunction with the painstaking resolution of complex claims and the approval of innovative motions by the United States Bankruptcy Court, 36,000 securities and commodities customers, many of whom were farmers and ranchers, received 100 percent distributions on their claims.

Secured creditors also received 100 percent distributions on their claims, and a final 95 percent distribution to non-affiliated unsecured creditors is now in the process of being completed—all within less than 4 years from the commencement of the proceeding.

Distributions to customers in these two liquidations far exceeded initial expectations and demonstrate the flexibility and effectiveness of SIPA in complex, large broker-dealer failures.

Considerations

While SIPA has proven to be a successful mechanism for liquidating broker-dealers and is indeed viewed as a model for the prompt return of customer property in different jurisdictions around the world, there is room for modernization and improvement.

The considerations that follow stem from my and my counsel's experience in Lehman, MF Global and several other liquidations and from my involvement, along with investor advocates, regulatory specialists and academic experts, in a Task Force that issued recommendations for modernizing SIPA.

Specifically, the SIPC Modernization Task Force report included 15 recommendations on how to amend and improve SIPA. In addition, my own investigation reports in the Lehman and MF Global liquidations included eight and six recommendations respectively on improvements to SIPA and related laws and regulations.

I incorporate these three extensive, public documents into my testimony today, and I urge the Subcommittee to consider all 29 of the reform proposals in detail. Among the recommendations in these reports, I would like to highlight the following eight potential reforms for your consideration in particular:

Task Force Recommendations

1) Increase Maximum Coverage to \$1.3 million

Increasing SIPC's maximum coverage from \$500,000 to \$1.3 million, and tying future coverage limits to inflation, would reflect a significant increase in protection for customers and is consistent with the level of protection that is necessary to protect nonprofessional investors.

2) Eliminate the Distinction in the Levels of Protection for Cash and Securities

Eliminating the distinction between claims for cash and claims for securities resolves potential disparate treatment of customers and increases the amount of protection available to customers of broker-dealers. Currently, the level of protection per customer is capped at \$500,000, up to \$250,000 of which may be in satisfaction of a customer's cash claim. This distinction leads to arbitrary resolution of claims between customers, may no longer reflect the way that cash and securities are held at broker-dealers, and has created confusion over the way that claims based on fictitious securities are treated.

3) International Cooperation

The collapse of MF Global and Lehman revealed significant gaps between protections afforded customers in U.S. and foreign countries, such as the United Kingdom, arising largely from differences in insolvency laws and the absence of clear legal precedent. Though there may not be a one-size-fits-all solution for these issues, customers would benefit from greater harmonization of rules governing the segregation of customer funds and treatment of omnibus accounts.

Lehman Investigation Report Recommendations

4) Pre-Planning

More pre-liquidation disaster planning, both on an individual broker-dealer and industry-wide basis, including a broker-dealer's "living will" and emergency plan, should alleviate the type of information gap that I and my staff confronted in the Lehman liquidation. Such pre-planning would indicate the categories of customer accounts and associated assets that would need to be protected and set forth how possible scenarios would be dealt with, ranging from complete liquidation of all cus-

tomers accounts to total or partial account transfer solutions, with details of key operational steps and the core assets that would have to remain to assure effective liquidation of customer accounts.

5) Increase in SIPC Borrowing Authority

In addition to increasing SIPC's maximum coverage as noted above, consideration should also be given to expanding the borrowing and guarantee authority available to SIPC trustees or other liquidators and to permitting more flexibility for use of those funds. While the previously existing SIPC fund had more than sufficed to meet the demands of all previous SIPA liquidations, the Lehman and Madoff liquidations in particular demonstrate that the failure of a single major SIPC member broker-dealer could require at least the temporary availability of much more substantial sums to support the quick and efficient return of customer property.

6) Earlier Involvement of a Customer Representative

A party with potential responsibility for customers interests—whether SIPC, a putative trustee, a regulator, or a combination of all of these—should be involved in the negotiations related to the sale of a failed broker-dealer. Parties representing customer interests should, with better planning and access to information, bargain against a clear baseline of what needs to be transferred and avoid subsequent uncertainty and surprises.

As experienced in the Lehman case, the seller's immediate focus is likely to be its own post-transaction survival; the purchaser's is with the customers and assets it is taking on, not those it is leaving behind.

MF Global Inc. Investigation Report and Prior Senate Banking Committee Testimony Recommendations

7) Strict Liability for Senior Officers and Directors

Because regulations require futures commission merchants (FCMs) to segregate customer funds at all times, it may be appropriate to impose civil fines in the event of a regulatory shortfall on the officers and directors who are responsible for signing the firm's financial statements. Where there is a shortfall in customer funds, Congress should consider making the officers and directors of the company accountable and personally and civilly liable for their certifications without any requirement of proving intent and without permitting them to defend on the basis that they delegated these essential duties and responsibilities to others.

8) Commodities Customer Protection Fund

The liquidation of MF Global would have played out differently had there been even a modest protection fund for commodities customers—that is, a separate and distinct analog to SIPA in the FCM arena that learns from and builds on SIPA's record of success. A fund limited to protecting these smaller accounts—representing many farmers and ranchers—could be of relatively modest size, but would suffice to make these customers whole very quickly even in a case with a shortfall the size of MF Global's. With such a fund in existence, three-quarters of MF Global's commodities customers could have been made whole within days of the bankruptcy filing.

Conclusion

Since 1970, the SIPA statute has succeeded in protecting customers of SIPC-member brokerage firms, and I believe strongly that the statute has met its policy goals. In particular, the Lehman and MF Global liquidations are an indication that SIPA, SIPC, and the concept of the liquidation trustee work to protect customers and return assets to them as quickly as possible in a manner that is fair and consistent with the law. With consideration given to modernizing elements of the statute and related laws and regulations, I believe the shared goal of continuing and strengthening protection of investors, particularly nonprofessional investors, can be achieved.

Thank you Chairman Crapo, Ranking Member Warner, and other Members of the Subcommittee for the opportunity to testify before you and to submit this testimony for the full record of the hearing.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT OF RICHARD R. CHEATHAM

SEPTEMBER 30, 2015

I'm a 72-year-old lawyer in Atlanta, officially retired at 1/1/2015 but still actively consulting with those who became responsible for my former clients. I obtained my undergraduate degree from the University of Virginia and my law degree from Harvard. I was fully active for slightly more than 45 years in a large firm practice representing primarily commercial banking institutions in corporate and regulatory matters.

I am also a slightly embarrassed victim of the Allen Stanford Ponzi scheme. I have a good excuse. My broker had and used discretionary authority. Prior to having a heart attack in 2007 I managed my own investments. Like many lawyers, I clearly see all risks and cannot bring myself to invest in anything not guaranteed by the full faith and credit of the U.S. Government. After the heart attack, realizing I might actually be required to retire, I gave discretionary authority to a contemporary of mine who I trusted. He later retired and left his clients in the care of his two sons. Against my better judgment, I kept my account with the sons, principally because I had a son just starting out and empathy kept me from communicating or acting on a lack of confidence in youth and inexperience. Subsequently, exercising their discretionary authority, without any action or instruction by me, the sons sold \$300,000 of my securities held by the Stanford SIPC insured firm and caused the proceeds to be transferred to the Stanford Ponzi scheme.

Before the SEC sued SIPC I had not paid much attention to the possibility of SIPC coverage. I was attempting to recover my losses from my individual brokers' insurance policies, an attempt so far frustrated by an injunction issued at the SEC's request in the Texas Receivership proceeding. I was vaguely aware that the SEC had initially taken the position that SIPC did not cover the Stanford victims, but I had not attempted to look at the coverage issue myself.

However, shortly after the SEC filed suit, I looked at some documents in the case to get a feel for what was going on. I don't recall exactly what I looked at, the complaint and answer or documents associated with some motion, but those documents made it apparent that SIPC was attempting to defend by creating a largely fictional factual scenario in which the Stanford scheme could be characterized as an investment gone bad rather than an intentional theft. SIPC also asserted, in an effort to avoid the SIPA "customer" definition, that the Stanford victims had dealt directly with the Antiguan bank and that no funds or custody securities held by the SIPC member were involved. That fictional scenario characterized the subject investment as a CD in an offshore bank. According to that scenario Stanford securities brokers "counseled investors to purchase certificates of deposit from an Antiguan bank . . . [and t]he Antiguan bank's CDs eventually became worthless."

The real facts are that the Antiguan bank was just the cover story for a massive Ponzi scheme theft. The CD's did not "become" worthless. The principal shareholder of the SIPC insured brokerage firm was using the funds generated by his firm's brokers (compensated by above market commissions) for personal purposes and to cover his prior thefts. Legally, that knowledge was imputable to the brokers who executed the thefts. The CDs were worthless and fictional from the get-go, just like Bernie Madoff's fake statements depicting fictional investments in his Ponzi scheme whose victims were protected by SIPC.

To avoid the SIPA "customer" definition, SIPC's creative "facts" assumed that each purchaser of the "CDs" opened an account with the offshore bank and sent a separate check or wire transfer directly to that bank and received a CD in return. The suggestion being that the transaction was wholly apart from and independent of the victim's relationship with the insured brokerage firm. That was certainly not true in my case. I had my "self-directed IRA" at Stanford. It was moved there from Morgan Keegan when my brokers changed firms. The Stanford brokerage firm was the fiduciary custodian of my securities and funds. As with any IRA I had no direct control over the funds and could not write a check or direct a wire transfer from my account with the SIPC insured firm. Without any action on my part, my Stanford brokers caused the sale of \$300,000 in my securities held by Stanford and "invested" the proceeds in the fake "Stanford CDs." In other words Stanford, the SIPC member, sold my custody securities and gave the proceeds to Alan Stanford for his personal use. Those facts support undeniable coverage by SIPC.

After looking at SEC/SIPC the case documents, I called Matthew Martens who was listed in the pleadings as the SEC's lead counsel. The purpose of the call was to describe my fact situation to make the SEC aware that SIPC's version of the facts was simply not true, at least for a substantial number of victims. The SEC only gets

one shot to force SIPC to cover claims against an insured defunct broker. If the facts support the claim of **any** customer for SIPC insurance, the SEC can force a SIPC receivership and let each individual customer make his/her claim. I wanted to make sure that the SEC knew that there were Stanford victims who did not fit within SIPC's hypothetical scenario. To my surprise Martens answered the call. I told him who I am and fully described the facts surrounding my becoming a Stanford victim. I told him I thought my facts and those of other IRA beneficiaries were "perfect" to demonstrate that funds and/or custody securities had been delivered to the SIPC member contrary to SIPC's theory of the case. He sounded appreciative and gave me the impression he was taking down my contact information. He assured me that I would receive a call from SEC staff.

I never received a call from SEC staff. That didn't bother me. I had just wanted to make sure the SEC was aware of fact patterns like mine to prevent its falling for the SIPC story line. I was sure that many, if not most, other victims had fact patterns more like mine than like SIPC's hypothetical.

Months later when I read the District Court's decision I was dumbfounded by the description of the fact stipulation that the SEC had agreed to in the case. The stipulation simply mimicked SIPC's creative hypothetical. Because of my conversation with Marten's I knew that the SEC was fully aware that the facts it stipulated simply were not true for all, perhaps most, of the Stanford victims, that the actual facts surrounding my "investment," and I assumed many others, were inconsistent with the factual assumptions included in the District Court's analysis. As a lawyer I understood that the SEC/SIPC fact stipulation, if it became "final" in the District Court case, would be dispositive on the issue of SIPC insurance for all the Stanford victims. Stanford victims could not sue SIPC directly, only the SEC could enforce their congressionally created rights. Also, under the universally recognized principle of *res judicata*, the SEC only gets "one bite at the apple." It has the right to bring one lawsuit to force SIPC to live up to its statutory obligations. The facts established in that lawsuit are binding on everyone forever. The SEC cannot bring a second suit hoping to prove a different set of facts supporting its claim.

After I read the decision, I called one of the law firms representing large groups of Stanford victims in various class actions to encourage it to intervene in the District Court case before it became final in order to contest the fact stipulation. Otherwise all Stanford victims would be bound by the stipulation in any efforts to recover their losses from SIPC insurance. The law firm, which wasn't involved in SIPC coverage issues, didn't seem interested. Thus, I reluctantly filed an intervention myself, reciting my facts and demonstrating why I believed the District Court would reach a different decision on "real facts" as opposed to the stipulated facts.

I didn't have much hope that my intervention would accomplish anything. Judges are understandably disinclined to question the competence or good faith of Federal administrative agencies. Nevertheless, the issue was critical to SIPC coverage for the Stanford victims. I had to try to do whatever I could. In my intervention petition I described my facts and made what I thought was a compelling case for a result different from the one Judge Wilkins reached on the stipulated facts.

In its response to my intervention, the SEC did not really argue that I was wrong on the merits. It essentially conceded that my facts were materially different from the stipulated facts and, by implication, that my facts might result in a different outcome. The SEC then cynically assured the District Judge that it would review my facts and, if warranted, commence a new action against SIPC to force a receivership with SIPC coverage. To me that response was an intentional misrepresentation by the SEC to the District Court. The SEC had known my facts for months. It did not need to investigate those facts. They were not that complicated. In addition, bringing a later action in an effort to prevail against SIPC on a different set of facts was precluded by *res judicata*.

In my reply to the SEC's opposition to my motion to intervene I pointed out that the SEC had known my facts for months and that a later action based on different facts would be precluded. However, Judge Wilkins never read my reply. I filed my reply late on Friday before Labor Day weekend. The Judge issued an order denying my intervention on Tuesday after the Monday holiday. As a *pro se* litigant I had to file a paper response, rather than an electronic one which would have been available to the Judge over the weekend. The Judge couldn't have seen my reply until that Tuesday. It's not realistic to assume that the judge read and considered my reply and then wrote and entered on the same day an order that never mentions my reply. He had obviously already written the decision and was just waiting for the time for my reply to expire before entering it.

I don't blame Judge Wilkins. Then, if I were a judge and the SEC assured me that it would protect an intervenor's interests, I would have denied the intervention. Intervenorers are often "nut cases." That's especially true in cases where a

Government agency charged with protecting a group of citizens is acting within its expertise and someone mere citizen wants to add in his two cents. The District Judge undoubtedly believed that the SEC would and could do what it said.

It was obvious that I couldn't get the District Judge's attention in the face of unprincipled SEC opposition. I had 30 days before the decision denying my intervention became final. My only chance was to see if I could get the SEC to correct its false assertions. Accordingly, on September 11, 2012, I sent an email to the SEC's David Mendel with a copy to Matthew Martens, as follows:

I was not surprised that Judge Wilkins did not read my reply brief after both the SEC and SIPC opposed the motion.

As I told you before, I still can't figure out where the SEC is coming from in this proceeding.

I didn't know this when I filed my motion, but the Receiver's Web site indicates that there were more than 1,400 Stanford Trust Company victims of the Ponzi scheme. Given the way the scheme operated, each of those victims had his/her IRA with SGC. While I recognize that the IRA relationship with an introducing broker is somewhat ambiguous, there is little doubt that SGC had control over those IRA funds sufficient to meet the "entrusting" test applied by Judge Wilkins. Contrary to paragraph 3 of your stipulation, none of those victims opened an account with SIBL and none of those victims wrote a check or wired funds to SIBL. In each case SGC, on its own, transferred money from the victim's IRA with either Pershing or J.P. Morgan and had funds wired from the custody broker to a third party bank (the bank recipients varied I am told). Where the funds went from there, I can only guess, but SGC certainly knew and I'll bet any amount that they ended up in the Ponzi scheme.

I don't think the SEC can sue SIPC again based on a different set of facts, though I'm certainly open to listening to your contrary theory if you have one. I suspect your suggestion to the contrary convinced Judge Wilkins to deny my motion without even reading my reply. If I appeal Judge Wilkins' order denying my motion, the Court of Appeals may overrule Judge Wilkins' denial, but the odds are against it. The Court of Appeals might, however, be influenced by the undisputed record that my facts are true and leave open my claims (but perhaps not others who didn't intervene). I don't see much hope for the 1,399 other IRA victims unless the SEC moves now to reconsider the denial of my motion and blows the fact stipulation.

There is some chance that the SEC can get a reversal of Judge Wilkins' 'entrusting' analysis, though I am doubtful in the DC Circuit. As I said in my reply, I agree with your conclusions. However, to me the 'entrusting' issue is a slippery slope. It sounds reasonably convincing on the stipulated facts, but not at all on the IRA facts. If you start your analysis with the IRA facts, you realize that your analysis on the stipulated facts is wrong. The SEC/SIPC fact stipulation starts at the bottom of the slippery slope and hopes that the judge will slide up.

The SEC can minimize its exposure here by moving that Judge Wilkins reconsider his denial of my motion and essentially reopening the case. If the trial court record closes as it is there are very serious publicity and pending litigation risks for the SEC that you can imagine as well as I can. I'm not going away and this issue is not going away. I am prepared to take the issue as far as I can. \$300,000 is a lot of money to me, and I don't have time to earn it back. I'm almost 70 and have time on my hands. I'm not a part of any Stanford victims group and really don't have any sympathy with such heavy-handedness. I don't even know (or want to know) any Louisiana Republicans. I'm not a mindless crusader. I am a pragmatic lawyer who prefers solutions that are in everyone's best interest. But, if that is unachievable, I can be a pig-headed lawyer who doesn't tire easily.

I'm on your side and, consistent with protecting the IRA victims, will do anything to advance our common cause.

Mendel and Martens did not reply. Not easily put off, I followed up with an email on September 21, 2012, as follows:

It has been well over a week since I sent you the email below. Yet, I have no response. Rule imposed time limits on motions to reconsider Judge Wilkins' September 4 order denying my motion to intervene are running. My patience is not limited solely by my psyche.

I've reached out to you a couple of times in an effort to commence a dialogue about ways we might achieve common goals without acrimony. I recognize that my motion to intervene could be interpreted as critical of your competence and/or good faith. My initial assumption has been that your agreement to the fact stipulation was an innocent mistake. I know you are both very busy. We all make mistakes, particularly in matters that are low on our priority lists.

Because the SEC initially decided not to bring this action, it has been asserted that the SEC only did so in response to political pressure. In that context, I can understand the SEC's possible ambivalence about the outcome. Politicians will claim credit if the suit is successful, and if you lose, the SEC's initial reluctance will appear more credible. I am sure that ambivalence impacts the SEC's priorities and your consequent attention to this litigation.

I understand your reluctance to begin a dialogue. If I were you, I would prefer that I just fade away. But, I won't. There is a possibility that no one will notice anything I file with the courts and that you will not be embarrassed by it. Given the emails I've received from Stanford victims I've never heard of, I doubt that. I do not intend to file anything embarrassing to you unless you force my hand.

At page 5 of your memorandum in opposition to my motion to intervene, you made the following statement:

'None of this is to say that there is no opportunity for Mr. Cheatham's situation to be addressed under SIPA. Consistent with SIPA, the Commission will consider Mr. Cheatham's factual situation, investigate his claims as necessary, and, if the Commission deems it appropriate, refer the facts to SIPC for appropriate action, including potentially a liquidation proceeding.'

That statement, based on my understanding of the law, is materially misleading in that it fails to disclose that even if the SEC took the action specified, unless the SEC prevails in this action based on the stipulated facts, SIPC could (and undoubtedly would) summarily deny any recommendation with respect to my claim by the SEC. If so, the SEC could not sue SIPC to overturn that summary denial. SIPC's success in this action would preclude any subsequent action by the SEC to seek the same remedy under principles of *res judicata* without regard to any differences between my facts and the SEC/SIPC stipulated facts.

Based on the foregoing misleading representation by the United States of America Government agency with principal responsibility for the protection of investors and the assurance of securities market integrity, I would have done exactly what Judge Wilkins did and denied my motion to intervene. I have asked you to provide me with whatever support you have that demonstrates the truth of your statement. You have not.

In my view, if your statement about your future ability to protect my interests and those of others similarly situated is not supportable, you are legally required to so inform Judge Wilkins.

Again I received no response. Undaunted, I sent another email to Mendel and Martens, this time simply directing them to the page at the DC Bar's Web site setting out its ethics rule 3.3:

Rule 3.3—Candor to Tribunal

(a) A lawyer shall not knowingly:

- (1) Make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer, unless correction would require disclosure of information that is prohibited by Rule

1.6; [3] Legal argument based on a knowingly false representation of law constitutes dishonesty toward the tribunal. A lawyer is not required to make a disinterested exposition of the law, but must recognize the existence of pertinent legal authorities. Furthermore, as stated in subparagraph (a)(3), an advocate has a duty to disclose directly adverse authority in the controlling jurisdiction that has not been disclosed by the opposing party and that is dispositive of a question at issue. The underlying concept is that legal argument is a discussion seeking to determine the legal premises properly applicable to the case.

Finally, a response from Martens:

We received your emails of September 11, September 21, and October 1, 2012. While we are aware of your disagreement with our litigating positions, we stand by the briefs filed and the stipulations entered into by the SEC in the SIPC matter. The stipulations are a fair representation of the facts as we understand them. We do not think that your particular circumstances, as described in your communications with us and in your District Court filings, change our analysis of the proper litigation posture for this case. And, for the reasons stated in our response to your motion to intervene, we do not think you met the appropriate standard for intervention in the District Court.

That said, SEC staff are gathering relevant records that pertain to you so that a determination can be made as to whether to refer your set of facts to SIPC for appropriate action. We are unaware of conclusive authority (nor have you cited any such authority, even in your Reply brief) that would foreclose the SEC from seeking additional action from SIPC with regard to holders of SIBL CDs on a materially different set of facts. If there is a *res judicata* defense that might be lodged against such a second effort, we do not think that we misled the Court in any way with respect to the potential existence of such a defense.

We understand your frustration with the outcome in the District Court. However, we disagree with your suggestions that I or other SEC attorneys have not met our professional responsibilities in this matter.

Another lie: "The stipulations are a fair representation of the facts as we understand them." The statement that there is no "conclusive authority" that *res judicata* would bar a subsequent action is a bit more subtle. It is possible that the U.S. Supreme Court could hold that the SEC's action against SIPC is an exception to the time honored principle of *res judicata*, but the odds against that are more than a million to one. I am not aware of any exception to the principles of candor that excuses probable lies that are not "conclusively" false. Finally, the SEC was not "gathering relevant records" that pertained to me. I had many of those records and was never asked for them by the SEC.

I was virtually certain that the Court of Appeals would affirm Judge Wilkins' decision based on the SEC/SIPC fact stipulation. It was obvious to me that the SEC legal staff had been totally captured by the securities industry. It did not surprise me that Martens soon left the SEC to join WilmerHale where he represents the industry. He probably made more than my \$300,000 in his first 3 months, but it will be a long time before he earns more than was lost by the other 1,399 Stanford IRA customers he shafted.

PREPARED STATEMENT OF LAURENCE KOTLIKOFF

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS FIELD HEARING
BATON ROUGE, LOUISIANA

AUGUST 3, 2015

Mr. Chairman, I deeply appreciate your invitation to participate in this hearing of the Senate Committee on Banking and Urban Affairs to review the performance of the Securities Investor Protection Corporation (SIPC) following the failure of Stanford Group Company (SGC), the SIPC member broker-dealer, which played a strategically important role in Allen Stanford's massive fraud by which he stole the investment deposits of some 8,000 customers for his private, personal use.

Like most Americans who place funds with a federally registered brokerage firm for investment in national and international equity and debt securities, I had paid little attention to the performance of SIPC in its administration of the Securities Investor Protection Act of 1970 (SIPA), assuming the advertised protection of up to \$500,000 per account would be readily available should the failure of your broker occur. However, the failure of Bernard Madoff's firm following his confession of Ponzi fraud—in which I personally know victims who suffered serious financial loss, with no help from SIPC—opened my eyes to the unsettling and shameful reality of SIPC's quick recourse to self-preservation mode.

If there were any lingering doubts as to self preservation being SIPC's prime motivation for its decisionmaking, they should be put to rest by its obstinate refusal to initiate a liquidation in the Stanford Financial Group fraud—capped by its arrogant judicial challenge to the directive from its plenary oversight authority, the Securities and Exchange Commission (SEC).

Certainly many of your colleagues, with constituencies untouched by either of these massive Ponzi frauds, simply have not acquainted themselves with the extent of SIPC's departure from the congressionally intended objectives of SIPA in 1970. That legislation was the product of earnest cooperation and constructive negotiation between the securities industry's leadership and the Congress with the active participation of the Nixon Administration's Treasury Department and the SEC. The statute was enacted in response to a rash of broker-dealer failures in order to boost investor confidence.

Today, no investor can be confident their assets are protected by SIPC as Congress intended when SIPA was enacted.

Senator Vitter, I commend you for holding this field hearing to build a record to educate your colleagues. I also commend the esteemed Chairman of the Senate Banking Committee, Senator Richard Shelby, for authorizing you to do so. It is vitally important for the national public to understand how SIPC's flawed administration of SIPA has denied the customer-victims of Allen Stanford's fraud the protection from total financial loss they have rightfully expected. As you well know, the personal suffering of your own constituents is a direct consequence of SIPC's narrow, hyper-technical perspective of its mission under SIPA's remedial provisions.

It is also vitally important that the public and your colleagues in Congress have a clear understanding of SIPC's misguided conduct and likewise the remarkably erroneous judicial decisions that have affirmed SIPC's actions—or in the Stanford case—glaring inaction.

It is absolutely beyond dispute that the preeminent congressional objective in the passage of SIPA was to bring stability to the national securities markets through the restoration—and then maintenance—of the general public's confidence in participating as investors in equity and debt securities. Maintaining that public confidence is even more important in 2015 than it was 1970 because of the exponential growth of the rank and file investors who participate in the securities market as a means of building a secure financial future.

It should be duly noted that SIPA was enacted as an amendment to the Federal securities laws and not as an amendment to the Federal Bankruptcy Act. Not only did SIPA establish a special liquidation process for failed SEC-registered and regulated broker dealer firms, but it included special provisions not available in a traditional bankruptcy liquidation administered under the U.S. Bankruptcy Code. These provisions were specially designed to maintain public confidence in securities investment and, thereby, stabilize the structure of our capital markets by giving priority to broker-dealer customer claims over all other unsecured creditors in the liquidation process.

The three most unique and critical features of SIPA that differentiate a SIPC-administered liquidation from a traditional bankruptcy proceeding are:

- (1) The SIPC Fund, capitalized by annual assessments of the securities firms, which provides a resource for mitigating losses not recoverable from the debtor's estate up to a cap of \$500,000 per customer account;
- (2) "Customer property," a privileged division of the debtor's estate, with prioritized claims allocations placing the brokerage firm's customers ahead of all other unsecured creditors; and
- (3) Repeated directives throughout the statute for promptness in actions for processing customer claims, due to the significant disruption to the financial affairs of individual customers.

For SIPA to fulfill its priority objective of maintaining public confidence in our securities markets, it is essential for SIPC and the Federal courts to be attentive to giving effect to these special features that are provided for in the unique liquidation proceedings administered under SIPA. Conflating SIPA's unique provisions, which are utterly separate from those of a traditional bankruptcy proceeding, is contrary to the very spirit in which SIPA was enacted.

Yet that is exactly what SIPC has done, and it has done so in the name of self-preservation—at the expense of innocent brokerage customers who entrust their savings to a SIPC-member firm.

SIPC's principal, self-serving misapplication of SIPA in the Stanford case was most evident in its abuse of discretion in its interpretation of the term "customer." SIPC chose to dance on the head of a pin by advancing legal arguments that gave credibility to a fraudulent shell company organized under the laws of Antigua and Barbuda, Stanford International Bank (SIB), rather than accepting the factual finding of U.S. Federal courts that landed Allen Stanford in prison with a 110-year sentence and a \$6 billion forfeiture fine.

By not recognizing the Stanford fraud as a closely controlled, unified scheme in which SGC served as the engine of a massive scheme created solely to misappropriate customer funds, SIPC was able to argue that the SIB CD investors were not SGC customers. SIPC, in its self-preservation mode, shockingly made legal arguments in direct conflict with the factual findings in numerous judicial proceedings in the District Court for the Northern District of Texas, and affirmed by the Fifth Circuit Court of Appeals.

Instead of accepting the findings of the other Courts, SIPC argued the legitimacy of SIB, and insisted it was a completely separate entity from the SIPC-member, SGC. By making this argument, SIPC had found its loophole to deny protection to investors whose funds were stolen by the owner of one of its member firms. SIPC determined those investors were SGC clients, but not its “customers” under SIPA, which SIPC astonishingly deemed a “statutory term of art” Congress used when enacting SIPC’s singular guiding statute—SIPA. The SEC, in the true spirit of SIPA, disagreed.

Allen Stanford owned and controlled the Stanford Financial Group of Companies, which included numerous corporate entities, including SGC and SIB. The U.S. Courts all the way up to the Supreme Court had already determined and/or acknowledged that ALL of Stanford entities operated as one unified, fraudulent enterprise operating out of Houston, Texas. SIPC disagreed.

While the District Court overseeing the Receivership proceedings of the Stanford entities determined that corporate disregard doctrine applied to SIB because, “It would defy logic and run afoul of equity to treat a fictitious corporation as a real entity.” But SIPC was not looking to see the logic.

The Receivership Court stated, “This Court will not engage in semantics that obfuscate the purpose of the statute” (in this instance, the Chapter 15 provision under the U.S. Bankruptcy Code). SIPC deemed itself a higher authority than the Receivership Court, and chose to engage in semantics in order to obfuscate the purpose of its guiding statute.

The Receivership Court determined that “not aggregating the entities . . . would perpetuate an injustice.” SIPC chose to perpetuate an injustice.

SIPC found none of the *factual* findings in dozens of civil litigation proceedings related to the liquidation of the Stanford estate to be persuasive. Instead, SIPC refused to accept the holistic view of Stanford’s fraudulent enterprise and remained adamant in its refusal to initiate a liquidation of SGC, the broker-dealer entity, with which all U.S. purchasers of the SIB CDs were obligated to sign *customer* agreements.

Faced with an implacably negative SIPC, customers of a failed broker-dealer such as SGC have only one avenue of recourse to have their cause reviewed by a Federal court—and that is to petition the SEC. The Stanford Victims Coalition (SVC), to its great credit, refused to surrender to SIPC’s arrogant obstinacy to recognize the facts in the Stanford case. The SVC generated thousands of pages of documentary evidence of the pivotal role played by the SIPC-member broker-dealer in the conduct of the fraud. With strong support from more than 100 Members of Congress, led by you, Senator Vitter, and Senator Cassidy, the SEC agreed with the view of Federal District Court that the Stanford fraud had to be viewed as a singular entity that acted through its most logical and obvious public interface—SGC, the SIPC-member broker dealer. By obliging prospective investors to register as customers of SGC, Stanford was assured that a sales force of FINRA Registered Representatives who would have direct access to wield their sales magic (and of course to be compensated generously from the customers’ deposited funds).

Using its express authority under SIPA, which gives unquestioned vitality to SEC’s role as plenary oversight authority over SIPC, the SEC Commissioners voted to direct SIPC to initiate a SIPA liquidation of SGC. After months of fruitless discussion with SIPC and its appointed Board, the SEC turned again to the statute and applied to the Federal District Court in the District of Columbia for an order in support of its directive for SIPC to initiate a liquidation of SGC. This marked the first time in the 44 years of SIPA’s history that the SEC had felt compelled to exercise this extraordinary power in its oversight authority.

The next chapter of this inconceivable saga should surely infuriate a preponderant majority in the Congress, and awaken all to their sworn obligation to ensure that the intent of the Congress—most particularly in remedial statutes such as SIPA—is faithfully fulfilled by those charged with administrative responsibility. In an act of indescribable arrogance and disobedience, SIPC refused to comply with the SEC’s directive and formally contested the SEC’s application for an order enforcing its directive to SIPC. The SEC had no choice but to invoke its legislative authority to initiate an enforcement action against SIPC by filing a lawsuit for its blatant failure to discharge its obligations under SIPA.

Regrettably, SIPC's insolent and irresponsible performance in this case has been eclipsed by decisions of both the District Court and the Circuit Court of Appeals for the District of Columbia upholding SIPC's legal challenge and denying the SEC's application for a Court order to enforce its directive to SIPC. The two Courts take different interpretive reasoning to reach the same indefensible conclusion. What their decisions have in common, other than outcome, is the application of SIPC-manipulated interpretations of SIPA that are completely devoid of logic and common-sense. Both decisions benefited from an inexplicable trial-level error by SEC counsel, by entering into a stipulation of facts, which erroneously asserted that SGC customers had direct contact with SIB and made their payments directly to SIB. The reality is that the contact was exclusively with SGC, and payments were executed on SGC's instruction.

It is vitally important for the Congress to understand the faulty interpretive reasoning of each Courts—particularly so because the Circuit Court's decision is now the current controlling case law concerning the extent of the authority granted by the Congress to the SEC in the oversight of SIPC's operations. Beginning with the District Court, it devoted most of its interpretative efforts to a determination of the standard of proof, which the SEC must meet to obtain the Court order enforcing its directive to SIPC. Since the SEC's request was unprecedented, there was no guiding case law, and SIPC used that reality to its advantage. Was the standard to be based on "probable cause," the standard applicable to SIPC applications to initiate SIPA liquidation? No, the Court decided that "due process" required a sterner burden, namely, "a preponderance of the evidence." It reached that conclusion by reasoning that since SIPC is a private entity funded by private firms, it should be accorded the same "due process" applicable to other private parties within the SEC's regulatory ambit—for example, a securities firm facing an enforcement action for alleged violation of the Federal securities laws. Even one trained in the "dismal science" rather than the law might conclude that the Court's reasoning doesn't pass the "apples and oranges" test. But that tortured reasoning, coupled with the SEC's stipulation blunder, was enough for the District Court to deny the SEC's application and effectively neuter the SEC's directive to its subsidiary agency.

The SEC took the matter to the Circuit Court of Appeals. Certainly this Court would see the folly of the District Court's analysis. And it did, but it also conjured a folly of its own. It didn't bother with the "standard of proof" issue. Moreover, it seemed to embrace the unified enterprise view that within Stanford's controlled empire, all of its parts were essentially interchangeable. But what appeared to be an enlightened view suddenly darkened when the Court embraced an equitable theory of consolidation by which a customer's legal relationship with the SIB as a CD holder is transferred to the broker-dealer, SGC. This finding opened the door for SIPC's back-up legal argument.

SIPC argued that "if" equitable consolidation was considered by the Court, the fact the CDs were "debt instruments"—as many securities are—the CD investor was "lending" money to the SIB; and therefore a claim with SIB for debt owed to its customers would be equivalent to a claim for SGC's debt—triggering a rarely used customer exclusion provision under SIPA which restricts claims that are for the overhead of the broker dealer. This exclusion was created in an amendment to SIPA to address claims for creditors who intentionally loaned funds to a brokerage firm that then became insolvent. Basically, the amendment to create this particular customer exclusion was to maintain the priority status a SIPA liquidation affords to investors who purchase securities from a brokerage firm over creditors who became a part owner of the firm—in other words, to protect those who invested WITH a brokerage firm, rather than IN a brokerage firm. By the way, SIPC advanced this same legal argument in at least three other very similar cases, which three different Circuit Courts deemed an invalid argument because—just like in the SIB CD purchasers—the customer's expectation was they were purchasing securities, not lending their money to their broker. Buttredding that argument three different times in three different cases didn't stop SIPC from making a last-ditch attempt to shun its obligation to protect investors. Such legal jabberwocky is adored by SIPC and its hired counsel, who make millions of dollars in profit in order to further SIPC self-preservation culture. Customer perspective and reasonable expectations be damned, it is what works for SIPC that counts.

At the end of all the excuses, which *did* pan out for SIPC merely because it out-lawyered the SEC, SIPC protection for securities investors cannot possibly deliver the confidence-building benefits contemplated by the Congress because investors are subject to highly technical rules and exclusions never intended when SIPA was enacted. Such an approach destroys the remedial purposes of the statute.

Additionally, Congress never intended to give legislative deference to a non-Government authority over the SEC. The result is SIPC operating above the law without regard for the intent of the remedial statute that created the organization.

Senator Vitter, I like to believe that our elected representatives much prefer commonsense over arcane legal theories. If I'm correct, then you and your colleagues will conclude that a Congress which, in drafting the SIPA, made repeated calls for prompt action would not give the SEC the express authority to direct SIPC to initiate a liquidation—then turn on a dime to give SIPC the right to challenge that directive. Such an inconsistency is sharply at odds with the intent for SIPA liquidations to proceed with promptness in order to protect investors and facilitate investor confidence. Moreover, it is highly destructive of the SEC's legal authority as plenary overseer of SIPC.

In conclusion, I'd like to express my strong support for S. 67: The Restoring Main Street Investor Protection and Confidence Act of 2015, which you have introduced in the Senate as a companion to the legislation authored in the House of Representatives by Congressman Garrett and Congresswoman Maloney, the Chairman and Ranking Member of the House Subcommittee on Capital Markets and Government Sponsored Enterprises. Passage of this legislation is urgently needed in order for investors across this country to be protected not only from thieves like Stanford and Madoff, but also from SIPC. Until Congress acts to restore the confidence building purposes of SIPA and to rectify the deeply flawed decision of the Second Circuit in the Madoff case and the equally problematic decision of the DC Circuit Court of Appeals in the Stanford case. Until then, the rank and file investor must be made aware of their own Government's lack of authority to force SIPC to protect their missing assets if their brokerage firm becomes insolvent. These investors must also keep in mind what level of protection covers his or her account if their brokerage firm fails and SIPC and its Trustee are permitted to value their Net Equity after the fact by using an absurd cash-in minus cash-out methodology Madoff customers have been stuck with.

Regrettably, until your legislation is enacted, that is the very real uncertain state of affairs confronting American investors. I earnestly hope that you and Chairman Shelby and your original co-sponsor from the 113th Congress, Senator Schumer will begin serious discussions among yourselves and with the co-sponsors of the House companion legislation, H.R. 1982, aimed at moving the legislation. It is my sincere belief that SIPC's misguided administration of SIPA and the Circuit Courts of Appeals' decisions affirming SIPC's actions pose a very real threat to U.S. investors. And the victims of the Madoff and Stanford frauds, numbering a total of over 10,000 innocent account holders including thousands of your own constituents here in Louisiana—most of whom are at, or near, retirement—have suffered for 6 years waiting for a just resolution of their victimization by SIPC. Please awaken your colleagues to their plight. Thank you again for this public hearing.